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Rebel Yellen

In the 3rd quarter the U.S. economy grew at an annualised 3.6 percent, its fastest pace since early 2012. In November, unemployment fell to a five-year low of 7.0 per cent as employers added 203,000 jobs, including gains in many in higher-paying sectors like manufacturing and construction. Job gains have now averaged 194,000 per month over 2013, continuing a dramatic turnaround from the 2008 – 2009 global financial crisis. In large part aided by the US Federal Reserve's (the Fed) $85 billion per month in asset purchases, the US economy is moving toward a long-term, self-sustaining recovery.

The improving jobs figures has led to louder calls for 'tapering' or decreasing the Fed's asset purchases, which may now be quickly approaching its midnight hour. Nonetheless, risk markets continue their rally toward new records as markets cry more, more, more.

However, looking closer at the employment data, it is easy to be suspect of the supposed strength of the numbers. For example, the employment-to-population ratio remains depressed; the civilian labour force has actually contracted in the past year; and the new jobs created are not coming in 'high-quality' industries. While it seems that QE seems to be working, there is a very reasonable argument to be made that the 7% unemployment number is a bit worse than it appears.

Employment growth

The table below shows the number of jobs the US has gained or lost since the beginning of 2008.

US Non-Farm Payroll

Year	Total	Monthly	Unemployment rate	
	Payroll (millions)	Average (thousands)	at beginning of year	at end of year
2008	**–4,732**	**–301**	5.00%	7.30%
2009	**–5,818**	**–421**	7.80%	9.90%
	–10,550	**–361**		
2010	2,078	85	9.80%	9.30%
2011	2,419	175	9.10%	8.50%
2012	2,253	183	8.30%	7.80%
2013*	2,745	194	7.90%	7.00%
	9,495	159		

* YTD
Source: Bloomberg

What is interesting from the table above is:

1. The US has recovered most of the job losses suffered in 2008 - 2009. The US economy still needs to produce an additional 1.2m jobs to recoup all the jobs lost. There have been nearly 9.4 million jobs created over the past 4 years;
2. Non-Farm Payroll numbers on average have been steadily increasing year on year (average 85K in 2010 to 194K in 2013);
3. If the payroll grows at 200k per month in 2014, the unemployment rate could drop to around 6.5% or lower in the next 6 months;
4. The main questions bridging the beginning 2008 5% unemployment rate (starting point) to our 6.5% estimate – is population growth and labour force participation. It would still likely require the creation of more than 11 million new jobs to bring the unemployment rate back to the starting point of 5% – pre Global Financial Crisis.

Implications for the Fed

While markets debate the timing of the Fed's tapering program, we believe the eventuality is mostly priced into risk markets. The more important question is related to the Fed's guidance on future rate hikes. While we believe future rate hikes are far on the horizon, beyond 2015, the Fed will need to provide greater clarity on its expected plans.

The Fed has already pledged to keep rates near zero, where they have been since late 2008, until the jobless rate hits 6.5 percent, as long as inflation does not threaten to rise above 2.5 percent. To ease market fears, the Fed could lower the unemployment threshold to 6.0% as they begin tapering, which would be like 'maintaining the same level of accommodation' according to Chicago Fed president, Charles Evans.

Another question the Fed needs to address is the length of the tapering process – over what period of time do they slow and stop the purchases? In the grand scheme of things, economic conditions in the US have not changed much since the September meeting. The major differences are that the employment picture is a bit more robust and the inflation picture is a bit more subdued. But many of the longer-term trends and risks are still very much the same. As a result, it would be very easy for Bernanke and Yellen to sit on their hands a little bit longer.

The risks of quick tapering – i.e. from $85 billion to zero over 6 months may have many unintended consequences.

1. A short tapering period could cause equity/risk assets (which have risen sharply over the past 5 years) to stall and stumble.
2. Interest rates could rise dramatically (US 10 year yields have risen nearly 100bps from the lows) – which would lead to rising borrowing costs and a potential slowdown in hiring.
3. Rising mortgage rates could cause the housing recovery to stall.
4. Consumers and investors could get cautious on spending as rates rise and bite into their savings.

The Fed will need to manage the exit from tapering very carefully. They do not want to remove the punch bowl too quickly as to undo most of the work they have done in propping up asset prices, which in turn created wealth, which lead to spending, corporate profitability etc., and ultimately economic recovery.

Our core view is that FOMC QE tapering is still likely to be a 2014 event. Relatively illiquid market conditions near year-end, risks of another government shutdown in January, concerns about the effects of the previous shutdown on longer-term business and consumer confidence, and uncertainty over the strength of consumer spending going into the holiday season all make the case for a December taper less compelling.

However, if there is a taper event, we would expect some comforting forward guidance. Remember, future Fed Governor Janet Yellen did say that the economy has 'farther to go to regain the ground lost in the crisis and the recession.' We believe that Yellen will err on the side of caution and risk giving us too much medicine (stimulus) as opposed to making us quit cold turkey.

Regardless, an extra couple months of buying $85 billion versus $75 billion is market noise. Markets are forward looking – they know tapering is coming in the next 3 months, but they also know Yellen is a lifelong dove. So whether we get the taper or not, we are likely where we have been for a long while – in a long-risk asset/low-for-long-short interest rate view. The price action following the jobs report confirmed the notion that positive economic data would trump any negatives associated with tapering. Many market participants expected bond yields to sell off and risk assets to underperform following the employment figures. That did not happen. Rather, we learned that so long as the Fed is perceived to be moderate, good news will continue to propel risk assets.

Implications for the RBA

The Reserve Bank of Australia (RBA) faces many challenges in managing monetary policy that is appropriate for the domestic economy.

1. There is increasing uncertainty surrounding the US Fed's tapering program. Tapering has driven and affected returns in global risk markets, including Australian equity and bond markets.
2. A strong AUD has left the Australian economy vulnerable should the Fed not taper soon.
3. The transition from the mining investment boom to the service and manufacturing sector will eventually occur, but much weaker exchange rate is needed.
4. The RBA's record low interest rates are gaining some traction in the broader economy, consumers are beginning to spend a little more and asset prices have increased, especially the housing market.
5. Australia has a non-mining sector that remains fairly subdued, an exchange rate that is 'uncomfortably high' and the uncertainty surrounding the Fed's taper.

In a recent article in the Business Spectator[1], Callam Pickering argues that 'The Fed's taper and its timing becomes a game changer for the domestic economy. Sort that out and a lot of the uncertainty goes away. The outlook will suddenly be much brighter for the Australian non-mining sector and the broader economy.'

He continues to argue, that 'the next move the RBA makes will depend to a great extent on when the Fed chooses to taper. To understand the RBA's decision-making requires an understanding of the self-imposed restrictions that the RBA uses to set interest rates. The RBA sets several restrictions on its behaviour, which are unwritten but help guide monetary policy. These restrictions make it more difficult for the RBA to make decisions during periods of great uncertainty'.

Mr Pickering concludes that 'First, we need to recognise that the RBA does not want to change policy frequently. This allows the RBA to communicate its intentions more effectively, helping market participants shape their expectations'.

'Second, central banks hate the prospect of quickly reversing a policy decision. If the RBA has to regularly reverse policy moves then it is an acknowledgement that they stuffed up. From their perspective this needs to be avoided'.

'Finally, we know that forecasting the economy is difficult, in fact there is ample evidence that the RBA cannot forecast the economy with anything near the accuracy required to be certain of policy moves (Why guesswork has a place at the RBA, November, 2012)'.

The Reserve Bank and most other central bankers around the world are held hostage to the actions of the Fed. We have a Reserve Bank that is concerned that any move made right now might need to be reversed. It is hardly a surprise that it is in wait-and-see mode. That won't change until the Fed's intentions become clearer. At the moment the RBA may only have to wait a couple of months for the Fed's taper. But if the Fed strings markets along and does not provide any clear indication of its

[1] Pickering, Callam, Business Spectator, "RBA caution to cushion a Fed fallout", Dec 5, 2013.

intentions then the RBA could quite realistically be left paralysed, remaining hostage to the Fed and without any clear policy direction.

Outlook for 2014

2014 will likely see a persistent tug of war between the market trying to price in better growth and the Fed trying to orchestrate a smooth exit. A deteriorating outlook for fixed income demand, combined with eroding credibility of forward guidance as data improves will likely be negative for US Treasuries. We like short maturity positions and believe shorter-dated bonds will outperform longer-dated bonds. Nonetheless, 2014 will prove to be a volatile year.

In 2014 we also expect:

1. The US Federal Reserve to begin tapering (but gradually).
2. Risk assets to continue to perform well (Equities, credit).
3. Easy monetary policy to continue in the developed economies.
4. Treasury yields to rise.
5. USD to strengthen vs. other major currencies.

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