KEYBRIDGE
RESEARCH

KEY INSIGHTS

August 23, 2013

FOMC Meeting Minutes and Prospects for Tapering of QE3

Key Insights

- On Wednesday the Fed released the minutes from its July 30-31 FOMC meeting and we here at Keybridge have been pouring over them to try to glean insights about what they might mean for a tapering of QE3 bond purchases.
- The mood of the overall group is shifting in a more hawkish direction. It certainly looks like the doves are being pushed to adopt the tapering stance, so now they are trying to put their best face on it.
- On balance, I judge the tone of the new data to suggest a slightly stronger US macroeconomy, and slightly more inflation in the system. In the minutes, several more dovish members of the FOMC expressed concern about continued lower than desired inflation—and suggested that this might be a reason to delay the start of tapering.
- If economic data in the next couple of weeks comes in stronger (especially watch the August employment numbers released on September 6) then the hawks will be emboldened and will push for a larger taper.

On Wednesday the Fed released the minutes from its July 30-31 FOMC meeting and we here at Keybridge have been pouring over them to try to glean insights about what they might mean for a tapering of QE3 bond purchases.

The Split on the FOMC Between Doves and Hawks is Growing

A split really is growing among Fed officials on the question of tapering.

A split really is growing among Fed officials on the question of tapering. Do not be fooled by the 11 to 1 vote in favor of current policies (with only Esther George of the Kansas City Fed dissenting), which seems to suggest that Bernanke is firmly in the driver's seat and they are (almost) one big happy agreeable family. Divining the statements that "a few participants said this", and "several participants said that", it is clear to me that the more hawkish caucus within the FOMC (George, Stein, non-voting member Fisher, etc.) is getting more and more vocal. Remember that FOMC meeting minutes are always skewed a little in favor of the chairman's view, and Chairman Bernanke has been a consistent dove on monetary policy. That is, the board secretary tends to round descriptions of the number of speakers—some, a few, several, many, etc.—in the Chairman's favor.

Given this, I think it is noteworthy that on many of the key debating points the minutes said that "several participants" expressed the more dovish (Bernanke) view and "several participants" expressed the more hawkish view. Historically, the minutes would say that "most participants" took the chairman's view and that "a

The mood of the overall group is shifting in a more hawkish direction.

few participants" took another view. Indeed, it seems pretty clear to me that Bernanke, Yellen, Rosengren, Evans, and maybe another dove or two on the FOMC probably would prefer not to start winding down QE3 this autumn. You can see this view in the statements about perhaps announcing a threshold "lower than 6.5%" for the unemployment rate as a trigger for ending the zero interest rate policy. However, the mood of the overall group is shifting in a more hawkish direction. It certainly looks like the doves are being pushed to adopt the tapering stance, so now they are trying to put their best face on it.

Is the Fed Really This Naïve?

I would have been shocked if markets had not linked a decision to start winding down QE3 to the question of the appropriateness of zero interest rates.

I am personally quite surprised that FOMC members appeared surprised that the markets were viewing their zero interest policy and QE3 as interlinked. Really?? Several members of the FOMC truly seem to have viewed zero interest rates and QE3 as separate policies, responding to different economic challenges, and able to have their own clocks and triggers. They seemed to think that the financial markets similarly would see them as separate policies. This strikes me as illustrating some academic naivety or a lack of "financial street smarts". Clearly they did QE3 because they were worried about the pace of economic growth and the unemployment rate. I would have been shocked if markets had not linked a decision to start winding down QE3 to the question of the appropriateness of zero interest rates. Clearly the Fed would like to convince the world that the two policies are totally independent, but I doubt they ever will.

Inflation Data Since the FOMC Should Allay Concerns That Inflation Is Too Low

On balance, I judge the tone of the new data to suggest a slightly stronger US macroeconomy, and slightly more inflation in the system.

Remember that although we are just reading the minutes to the Fed's July 30-31, 2013 FOMC meeting now, we have nearly a month's worth of new economic data since then. On balance, I judge the tone of the new data to suggest a slightly stronger US macroeconomy, and slightly more inflation in the system. In the minutes, several more dovish members of the FOMC expressed concern about continued lower than desired inflation—and suggested that this might be a reason to delay the start of tapering. However, July's inflation data was up. The personal consumption deflator was up a sharp 0.4% in June (released the day after the FOMC meeting ended), and the year on year change rose from 1.1% in May to 1.3% in June.

CPI inflation was up 0.2% in July (released on August 15) and year on year CPI is now up 2.0% (up from the 1.8% June figure the Fed knew about at its meeting.) Core CPI was also up 0.2% in July to 1.7% year on year (up from 1.6% year on year in June). None of these data are sharply inflationary, but in my opinion, they are all a step in the direction of more inflation rather than less inflation, which was the FOMC's stated concern. So the latest inflation data should make a September start of tapering a little more likely.

Most notable to me is the continued downward movement of initial claims for unemployment in the month since the FOMC meeting.

Labor Market and Macro Data Slightly Positive Since FOMC Meeting

Likewise growth and employment data are slightly more positive than what was known on July 30-31. Most notable to me is the continued downward movement of initial claims for unemployment in the month since the FOMC meeting. The moving average of these claims in the 4 weeks before July 30-31 was 341,750. In the latest 4 weeks the number has averaged 330,500. This is one clear step in the stronger direction. The July jobs report was solid but not bullish at 162,000 payroll jobs and we lost 26,000 prior jobs with revisions, but the decline in the unemployment rate from 7.6% when the FOMC met to 7.4% now has to be considered a positive development.

Otherwise, housing data suggests that this sector continues to recover moderately and prices are still rising smartly. And cars sales have recently moved sideways, but remain at a high level. Finally, we learned that real disposable income in the US increased at an annual rate of 3.4% in the past 3 months (Q2 vs. Q1) on the morning of the second day of the FOMC meeting—one of the strongest quarterly real income gains in the past couple of years. This is another small plus for the macroeconomy, suggesting a little more momentum moving into Q3.

If economic data in the next couple of weeks comes in stronger, then the hawks will be emboldened and will push for a larger taper.

Bottom Line

While the case is not clear cut, the gradually strengthening data in the past 4 weeks suggests that Fed tapering of QE3 will likely begin in September. The number will probably be in the range of $15-20 billion (that is, purchases of $65-70 billion a month.) The exact number will be a negotiation between the doves and the hawks. If economic data in the next couple of weeks comes in stronger (especially watch the August employment numbers released on September 6) then the hawks will be emboldened and will push for a larger taper.

For example, I would bet that if the August jobs number is greater than 200,000, they would go for a number in the $20 billion range. If it is a weak employment report, the doves will push for a smaller number. But overall, don't miss the point that the financial imbalances hawks at the Fed seem to be gradually gaining ground on the doves. If for any reason tapering does not start in September, it almost certainly will start by October-November as long as the economy generates at least 150,000 – 180,000 jobs a month in coming months and the unemployment rate does not back up.