

CAMRI Global Perspectives

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Will Changed Leadership Matter?

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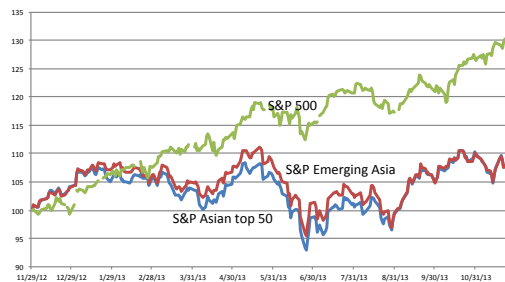
Remembering ‘Taper Terror’

It is 6 months since ‘taper terror’, the Fed’s attempt to guide the financial markets into preparing for the end of QE, and one month before the Federal Reserve’s chairmanship shifts from Ben Bernanke to Janet Yellen. All market participants will remember the sharp sell-off in financial markets around the world especially in emerging markets when Chairman Bernanke altered Fed guidance this past May. US markets suffered too as stock prices initially dropped 6% and bond yields initially rose by approximately 100bp. By early July the Fed and the chairman changed their rhetoric and most markets reversed directions.

As time passed, financial markets recovered nearly all of their losses: emerging market equities in Asia recovered and US stocks climbed to new highs. However, the US bond markets remain more than 100bp above their pre-taper levels. In between

then and now financial markets suffered through another

US Stocks Outperformed Asian Markets in Past year



US budget and debt ceiling crisis, and a sudden drop in US GDP growth in Q4. The congressional dysfunction over the debt crisis disrupted US business confidence, and dented global investor confidence in the role of the dollar as the global reserve currency. Are appreciated equity markets as vulnerable to the Fed’s next taper announcement as they were in May? The answer is no! First, the initial shock has been felt and some market portfolio adjustments have been made; secondly,

there is a new Fed chairwoman who is more dovish.

Hostage to Congress

Since Congress could not reach a compromise solution to the budget issue they merely kicked the budget dilemma into early 2014. Thus, another budget crisis looms in Q1. Unfortunately, budget crises have a nasty habit of interfering with business investment and investor confidence. And since there are no apparent signs on the political horizon that would give hope for a compromise solution to be reached Q1 GDP growth will again be undermined by political posturing. Therefore, the Fed’s Q1 meeting debates and policy decisions will again be hostage to the political paralysis in Congress.

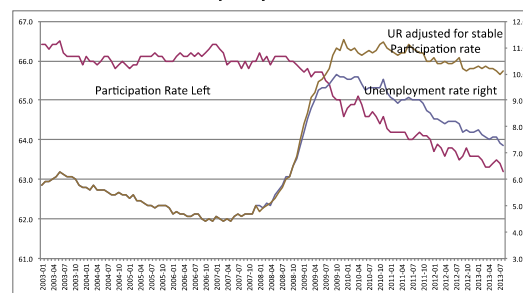
Consequently, the next round of taper guidance will likely be delayed at least until mid-year; and if Congress again kicks 2014 budget authority, and a more permanent increase to the debt ceiling legislation a few months further into 2014, a change in the Fed’s taper guidance will be postponed even further, perhaps until late 2014.

More Dovish Chairwoman

When Chairman Bernanke assumed the role of chairman the critics used to warn of ‘Helicopter Ben’, now they will have to consider Janet Yellen, who as a voting member of the FOMC has always been on the most dovish side of all Fed decisions from her first vote, when she became a

voting member of the FOMC in 2004, as President of the Federal Reserve Bank of San Francisco, until today. She has supported all the decisions on QE and is considered more dovish on labor market conditions than Chairman Bernanke.

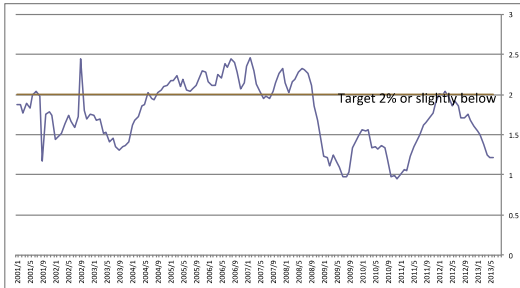
Falling Participation Biases
Unemployment Rate



The adjusted unemployment rate

She is verbally more concerned about the quality of the labor market and supports adjusting the unemployment data to reflect the huge reduction in the participation rate. Chart 1 reflects one version of this adjustment to the unemployment rate. The unemployment rate would be hovering around an unacceptably high 10%, if it were adjusted for a stable participation rate. This implies that a bigger improvement in labor market conditions will have to be made than is implied by the unadjusted unemployment rate before a change in monetary policy would be made.

Fed's Preferred Inflation Measure :Core PCE Below Target (% chg. YA)



The New Chairwoman's Inheritance

She inherits a very asymmetrical policy position: the Fed's balance sheet is bloated, official interest rates are approximately zero, and the economy is facing more fiscal tightening. She has very little room to maneuver if the economy suddenly stops growing, or if inflation keeps decelerating. Year-over-year inflation rates measured by the core personal consumption deflator and the CPI are well below the Fed's 2%, or slightly below standard, and have been dropping quite steadily for the past 5 years. Additional fiscal tightening, which is on the horizon, will not ease either situation.

Financial Markets Don't Completely Trust the Fed

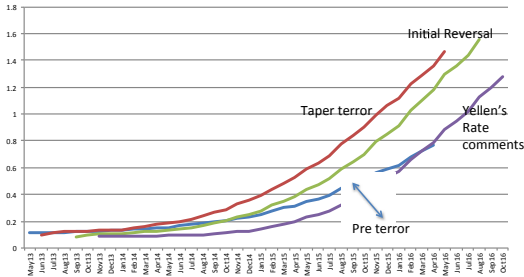
The FOMC is presently grappling with the wording they will ultimately use to alert the financial markets over the end of QE so as not to shock them again and cause another round of capital flight. Meanwhile, the markets continue to believe that the Fed will begin to raise the Fed Funds rate long

before the official FOMC policy statement implies.

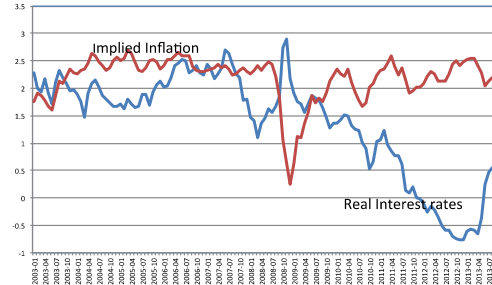
In their latest policy directive in October 23rd the FOMC said *'the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.'* However, the latest Fed Funds futures market curve implies that the Fed will begin raising rates by Q4 2015.

Although the FOMC has been very consistent with its language on the Fed Funds rate, market interpretations have varied significantly, and usually the changes were based on statements made by Fed officials on the tapering of QE. The markets sense that once the FOMC begins to taper QE purchases it won't be long before the Fed begins to raise the funds rate.

Yellen's Comments Sooth Expectations



Implied Inflation Remains Constant (10 yr. Tr. Inflation Indexed)



The Taylor Rule Suggests 2%

The markets haven't been all wrong. Using the famous Taylor rule* and the midpoint of the FOMC's own economic projections, their estimated potential economic growth rate and their desired inflation rate, the Fed funds rate should be at 2% in 2014 and slightly higher in 2015. The FOMC has consistently forecast that economic growth would climb above its estimated potential growth rate throughout their forecast horizon. However, incoming Chairman Yellen stated in recent testimony that that 'the gap between the taper and the normalization of short-term interest rates is going to be further apart than expected'.

Higher Tolerance for More Inflation

Therefore, the FOMC is considering ways to make their statement on policy rates more explicit. Since inflation expectations measured either by survey or implied from the Treasury TIPs market have also been relatively steady throughout the post crisis years, fluctuating between 2% and 2.5%, the FOMC has some room to maneuver.

One way to increase the market's conviction is to link policy rate changes directly to acceleration in the rate of inflation. By specifically acknowledging tolerance of inflation above 2% for an extended period the FOMC would signal there intent to have more leeway to keep rates low for longer than if they were to keep to a strict 2% inflation guide. This kind of policy guidance would probably appeal to the more dovish new Fed chairwoman.

Yellen Is for Rates to be Low for Longer

In a 1995 meeting of the Federal Open Market Committee while serving on the Board of Governors of the Federal Reserve System, incoming Chairperson Yellen stated that occasionally letting inflation rise could be a "wise and humane policy" if it increases output. At the same meeting she also claimed that each percentage point reduction in inflation results in a 4.4 percent loss of GDP. With core inflation running a full percentage point below the Fed's intended level, Chairwoman Yellen believes it is costing substantial loss in

economic growth and employment. To take her at her word, the rate increases will probably not begin until 2016. Consequently, the Yellen Fed will probably be more transparent with its guidance, more tolerant of inflation, and more attuned to the problems in the labor market.

* The Taylor rule named for the former FOMC governor and Stanford University professor, John Taylor, gained prominence more than two decades ago and has been a reasonably good indicator of the Fed Funds rate given the FOMC's twin policy objectives. It states that the Fed's policy rate should equal: $2\% + 0.5*(\text{GDP growth-potential}) + 0.5*(\text{the inflation rate} - \text{its target rate})$.

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KEY INDICATORS TABLE (AS OF 2 December 2013)								
INDEX	LEVEL (LC)	%1MO (LC)	%1MO (USD)	%1YR (LC)	%1YR (USD)	INDEX	LEVEL	%1YR
S&P500	1805.81	3.05%	3.05%	30.29%	30.29%	3MO LIBOR	0.24	-23.00
FTSE	6650.57	-0.79%	1.13%	18.03%	20.46%	10YR UST	2.74	69.88
NIKKEI	15661.87	9.31%	4.88%	68.66%	35.84%	10YR BUND	1.69	22.19
HANG SENG	23881.29	2.97%	2.98%	12.30%	12.27%	10YR SPG	4.12	-22.51
STI	3176.35	-1.00%	-2.08%	6.77%	3.92%	10YR SGS	2.40	83.67
EUR	1.36	0.05%		4.66%		US ISM	57.30	13.00
YEN	102.44	4.15%		24.20%		EU PMI	51.60	11.00
CMCI	1436.37	-1.01%		-9.83%		JP TANKAN	2.00	133.33
Oil	92.72	-3.80%		4.29%		CHINA IP	10.30	2.00

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US\$ where applicable)

S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)

FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)

NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)

HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)

STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)

EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)

YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)

CMCI: Constant Maturity Commodity Index (CMCIPI)

Oil: West Texas Intermediate prices, \$ per barrel (CLK1)

3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)

10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)

10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)

10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)

10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)

US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)

EU PMI: Purchasing Managers' index for the 17-country EU region (PMITMEZ)

JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)

CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)

LC: Local Currency

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