First Trust
Monday Morning OUTLOOK
November 11th, 2013
630-517-7756 • www.ftportfolios.com

Taper Talk

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – Dep. Chief *Economist*
Strider Elass – *Economist*

Tapering…please bring it on. We wanted it yesterday, or last month, or even years ago. We never thought QE helped the economy and certainly don't think keeping it around is a good idea. It's created uncertainty at an unprecedented level.

But, we aren't holding our breath waiting for the Fed to change course. Despite better data on the economy, the Fed will take its sweet time, possibly waiting until March before slowing the pace of "quantitative easing," the monthly purchase of $85 billion in long-term securities. With Vice-Chair Janet Yellen on tap for the top spot at the Fed and more potential budget fights looming in January/February, it's hard to imagine the Fed rushing to do something that might spook the markets.

However, in addition to Yellen's promotion, another change is afoot at the central bank that dovetails (pun intended) well with her ascent. A recent study by Fed staffers says monetary policy would be more effective at boosting economic growth if policymakers signaled their intentions by using the unemployment rate as the trigger for rate hikes.

At present, the Fed says as long as its own forecast of inflation stays below 2.5% it won't even consider rate hikes until the unemployment rate hits 6.5%. But the new paper suggests the Fed would get more economic bang for the buck from this forward commitment if it cut the jobless threshold to 5.5% instead. The theory is that by committing to a longer time period for a zero federal funds rate, the Fed could hold long-term interest rates down, which would stimulate the economy.

In other words, the new study has given the Fed a way to move forward with tapering and, in its own view, loosen monetary policy at the same time.

The Fed is, in effect, admitting that quantitative easing was never the reason long-term interest rates fell in the first place. It wasn't the amount or make-up of bonds the Fed was buying that mattered; instead, quantitative easing was just a tool the Fed could use to signal how long that short-term rates would stay at zero. The more securities the Fed would buy and the longer it committed to buying them, the longer it would take to end those purchases, which meant the longer it would be before the Fed finally got around to raising short-term rates.

And with long-term interest rates largely a function of expected short-term rates over the same time horizon, prolonging expectations of zero short term rates meant – violà – long-term rates fell and stayed down as well. Think about it. If you could guarantee that overnight interest rates would be zero for the next three years, the yield on the 3-year Treasury would be very close to zero as well.

The problem with all this new chatter about reducing the unemployment threshold is that it doesn't adequately contemplate how policymakers a few years down the road will react, when the economy hits this lower threshold. The new Fed paper assumes a future Fed will move up short-term rates aggressively enough to prevent inflation from becoming a persistent problem. Inflation might stay above the 2% long-run goal for a little while, the theory goes, but the Fed would then wrestle it back down.

We're more inclined to think that after tasting inflation above 2% for a couple of years the Fed will, due to either political pressure or an ideology it doesn't want to fully reveal, look for excuses to accept a new long-run inflation target above 2%, and then above 2.5%, and then, maybe, at or above 3%.

We're not saying the US is doomed to repeat the same exact mistakes of the 1970s with double-digit inflation. But a hallmark of that period was a never-ending stream of excuses for not stabilizing prices. The Fed has just found a new excuse and investors should plan accordingly. The days of 1% inflation are nearing an end. Look out above.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-14 / 7:30 am	Initial Claims – Nov 9	330K	**334K**		336K
7:30 am	Int'l Trade Balance – Sep	-$39.0	**-$39.2**		-$38.8 Bil
7:30 am	Q3 Non-Farm Productivity	+2.0%	**+2.8%**		+2.3%
7:30 am	Q3 Unit Labor Costs	+0.4%	**-0.3%**		0.0%
11-15 / 7:30 am	Import Prices – Oct	-0.4%	**-0.7%**		+0.2%
7:30 am	Export Prices – Oct	+0.1%	**-0.1%**		+0.3%
7:30 am	Empire State Mfg Survey – Nov	5.0	**4.5**		1.5
8:15 am	Industrial Production – Oct	+0.2%	**+0.2%**		+0.6%
8:15 am	Capacity Utilization – Oct	78.3%	**78.4%**		78.3%