ADVISOR PERSPECTIVES

FOMC Preview: Taper Likely To Be Deferred or Minimal

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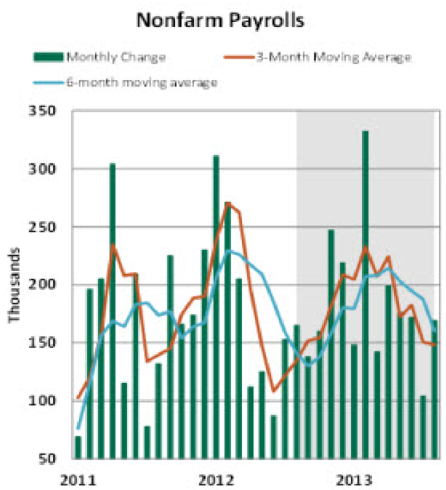
by Team
of Northern Trust

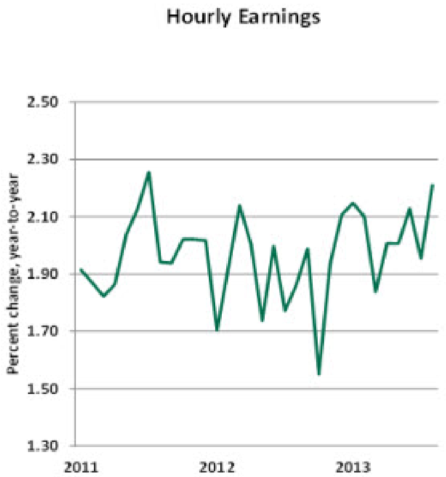
Market participants have been working overtime to refine their expectations of what the Federal Open Market Committee (FOMC) might do at its meeting next week. Many are calling for a cut in the Fed's pace of asset purchases from the current level of $85 billion per month.

Developments in the labor market are at the center of the Fed's current monetary policy. Forward guidance has been framed in terms of thresholds of future unemployment rates that would trigger changes of course. Chairman Bernanke noted that a jobless rate of roughly 7.0% could prompt the end of the Fed's asset purchase program, and a 6.5% unemployment rate would initiate deliberations about raising the federal funds rate.

Incoming economic data in the United States have been mixed, with plenty of evidence to support either a continuation of current policy or a tapering of asset purchases. Here are both sides of the argument, so you can take a stance.

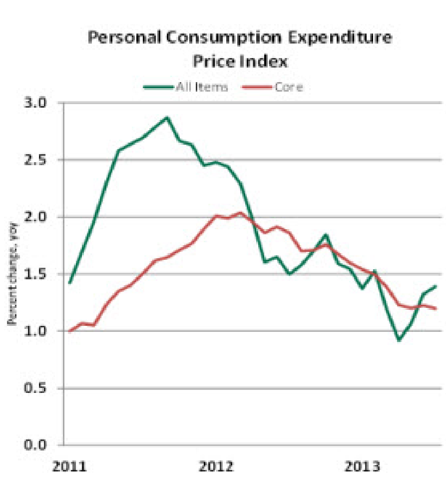
Full Employment Mandate - Labor Market	
Steady	**Taper**
The latest data point to softer labor market conditions. The drop in the unemployment rate to 7.3% would have been compelling if the participation rate had not declined to a new cycle low. Payroll employment shows a decelerating trend in the past six months.	The jobless rate has declined since the asset purchase program commenced, hourly earnings rose 2.2% from a year ago in August (the best reading since July 2011), and initial jobless claims are nearly down to pre-recession levels.

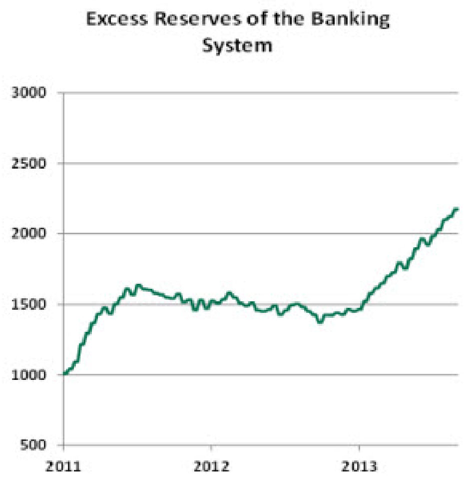




Source: BLS, Haver Analytics

Price Stability Mandate - Inflation	
Steady	**Taper**
The Fed's preferred measures of inflation, the year-to-year gains of the personal consumption expenditure price index and the core price gauge, which excludes food and energy, stand at 1.4% and 1.2%, respectively. These readings are far below the Fed's short-term inflation threshold of 2.5% and long-term inflation target of 2.0%.	Markets view the open-ended approach to asset purchases as inflationary, particularly in an environment of advancing excess reserves. These reserves have risen by $750 billion since the asset purchase program was reinstated in 2012. Should these reserves be released into the lending markets, the price level may come under renewed stress.





Source: BEA, Federal Reserve Board, Haver Analytics

Implicit Mandate - Asset Prices	
Steady	**Taper**
Advocates of asset purchases believe that as long as benefits exceed costs and the jobless rate is elevated, asset purchases should remain in place. Earlier this week, President John Williams of the San Francisco Fed pointed out the recent increase in interest rates has removed some froth from financial markets. There are no obvious bubbles on the horizon today, and supervisory policy can deal with them if they begin to appear.	Home prices have moved up and so have equity prices. Both reflect improving economic conditions and do not represent excesses that require attention. But, there is a great deal of concern about where asset prices might go down the road; inexpensive credit was a catalyst for the housing price bubble that we are still cleaning up. Beginning the process of reducing asset purchases will lower the risk that bubbles will develop.

Other Factors	
Steady	**Taper**
Uncertainty surrounding the upcoming budget and debt ceiling battle is a source of downside risk for the economy and markets. The crisis in Syria will continue to influence market volatility, and the potential for interruption in oil production and transportation has pressed energy prices higher. If risks to the outlook are weighted to the down side, better to wait.	We've had 16 quarters of economic growth. The housing sector shows more than nascent signs of recovery. The worst of fiscal belt tightening is behind. Headwinds from Europe and China appear to be moderating. Overall, risks to economic growth have diminished, and the need for added monetary accommodation has declined.

In our view, incoming data do not offer evidence strong enough to support expectations that the Fed will commence tapering of asset purchases on September 18. The risk environment has become more worrisome since the last FOMC meeting in July. It should also be noted that the sharp increase in long-term rates has already tightened credit to a noticeable degree in the mortgage markets.

There are those who say that working the quantitative easing program down is going to be a protracted process, one which the Fed should begin with a small step. Failing to do so, this camp suggests, would expose markets to further uncertainty. But the market is already looking far down the road to the evolution of monetary policy in the coming years, and it is not clear that a token reduction in asset purchases will add much clarity to the outlook.

While we'll all be intently focused on the FOMC's headline decision, the Fed also will release new economic projections at the conclusion of next week's meeting. These deserve some close attention for clues on how the members see the growth and employment picture evolving over the coming three years. We'll have a recap of the central bank decision after it comes out next Wednesday.