US Update

Calm before the storm?

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- Markets seem in a state of calm right now, but the boredom might not last long. After a few more tapering steps markets will likely focus completely on the Fed's eventual exit from its ultra-easy policy stance.
- We remain sceptical on the idea of low-for-long – an idea recently pushed by Fed officials. The Fed seems suddenly to ignore that its huge balance sheet will continue to provide stimulus for several years, even after QE ends. Fed's QE programmes could still be worth more than 200 bp on the fed funds rate in late 2016.
- We outline our expectations for the Fed's strategy for eventually returning to a normal policy stance. The Fed's key tightening tools will be interest rates rather than asset sales. Asset sales are not likely in coming years.

Markets seem in a state of calm right now. The Fed has removed almost all uncertainty about its monthly asset purchases by laying out a path for the buying to end by Q4 this year. But as former vice chairman of the Fed Alan Blinder argued last week, the boredom might not last long. Once the Fed announces a few more USD 10bn-a-month reductions of bond purchases, the markets will likely focus completely on the central bank's eventual exit from its ultra-easy policy stance. Attention will shift to:

- the timing of lift-off,
- the pace of tightening after lift-off,
- where short-term rates are ultimately headed over the longer-term and
- how quickly the Fed's balance sheet will shrink.

As the unemployment rate falls further, a heated debate between Fed doves and hawks on the Fed's exit strategy could be a source of turbulence, long before the Fed ever acts. That is one lesson of the market turmoil set off last summer when Bernanke started talking about tapering of the Fed's purchases. Add to this the point made by outgoing Fed governor Jeremy Stein, who recently reminded us that the Fed is in the middle of a policy transition that renders its guidance to markets "more qualitative", "less deterministic" and, therefore, less precise.

Thus, we better prepare for an eventful second half of 2014. As the minutes of the 29-30 April FOMC minutes showed, Fed officials have started discussing a revised exit strategy for eventually returning to a normal policy stance, and our best guess is that a new plan will be released by the end of July.

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Timing of lift-off

The timing of the first rate hike is obviously highly dependent on how the economy evolves. Given the 1% median FOMC projection for the fed funds rate by end-2015 and an assumed modest 25 bp of tightening per FOMC meeting, this would place the first rate hike in Q3 next year, or little less than a year after the expected end to QE, if the economy develops as currently expected by the Fed.

Mainly because we project higher inflation than the Fed, we have pencilled in the first hike already in Q1 2015. Thus, we continue to see both headline and core CPI inflation close to the Fed's 2% target by end-2014. Futures markets are currently pricing in the first Fed rate hike (of 25 bp) around mid-2015.

Terminal fed funds rate

Fed's low-for-long idea

The discussion of where short-term rates are ultimately headed over the longer term is much more important than the timing of lift-off, in our view. Fed officials argue that the neutral or equilibrium fed funds rate will likely for a long time be lower than in the past. Last week New York Fed President Dudley pointed to three reasons for this view:

- Headwinds from the financial crisis, with greater precautionary savings and less investment
- Lower potential GDP growth, due to the aging of the population and moderate productivity growth
- Increased bank regulation after the crisis

Putting all these factors together, Dudley expects that the fed funds rate consistent with the Fed's 2% inflation target over the long run is likely to be well below the 4½% average level that has applied historically when inflation was around 2%. The FOMC's estimate of the long-run neutral fed funds rate is currently 4%.

Fed: a fed funds rate of 2.25% with full employment

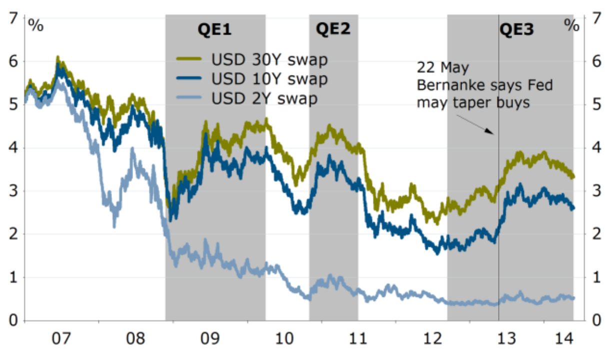
It is for exactly the same reasons that the median FOMC projection of the fed funds rate is only 2.25% by end-2016, even though the economy is believed to be back at full employment and inflation has returned to target at that time. This sharply contrasts with a level of around 4% implied by a standard Taylor model. During the tightening cycle that ended in 2006 the Fed raised the fed funds rate to 5.25%. In 2000 it pushed it to 6.50%.

The fact that several Fed officials have recently pushed this new low-for-long idea is probably a key reason behind the drop in 10-year Treasury bond yields from around 3% in early January to currently 2.55%. Currently the December 2016 Eurodollar futures contract prices in an implied fed funds rate of 1.91%, below the (dovish) median FOMC forecast of 2.25% (see chart).

Fed ignores the impact of its huge balance sheet

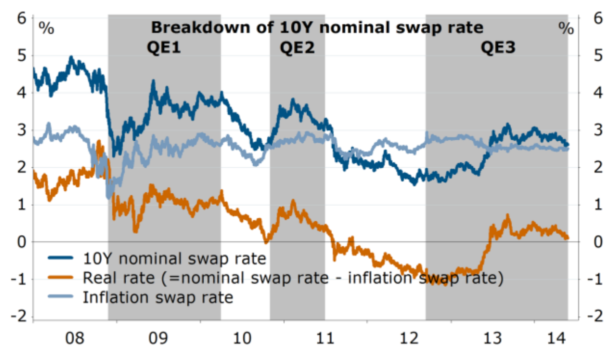
We, however, remain sceptical on the idea of low-for-long. After all, 2016 will be almost a full decade after the crisis began. In addition, the Fed seems

Lower rates since early January…



Source: Nordea Markets and Reuters Ecowin

… mainly driven by lower real rates



Source: Nordea Markets and Reuters Ecowin suddenly to ignore that its huge balance sheet will continue to provide stimulus for several years, even after QE ends. This is rather strange considering that the Fed believes that it is primarily the stock effect, based on the level of its asset holdings, rather than the flow effect, based on changes to its holdings, that determines stimulus.

Chairman Bernanke said in March 2011 that the Fed's USD 600bn QE2 programme was equivalent to roughly a 75 bp cut in the fed funds rate, an assessment recently confirmed by San Francisco President Williams. Based on this estimate, the more than USD 3.5trn increase in the Fed's security holdings since the crisis began should be worth more than 400 bp of easing via the fed funds rate. Admittedly, this calculation is a rough estimate, and the Fed's holdings are likely to decline over time as interest rise and bonds mature.

Fed's QE programmes could still be worth more than 200 bp on the fed funds rate in late 2016

Using a more conservative estimate and a projection of the Fed's balance sheet by Fed staff economists, the Fed's QE programmes could still be worth more than 200 bp on the fed funds rate in late 2016.

If so, a 2.25% fed funds rate, in line with the FOMC's current median forecast, would be equivalent to an extremely easy policy at a time when the Fed expects full employment.

It is against this background we believe that the Fed will have to raise rates more quickly than currently indicated by the Fed, with the fed funds rate returning to a neutral level of around 4% by end-2017. Based on current pricing of the Eurodollar futures contracts such a level is not priced in until late 2020 (see chart below).

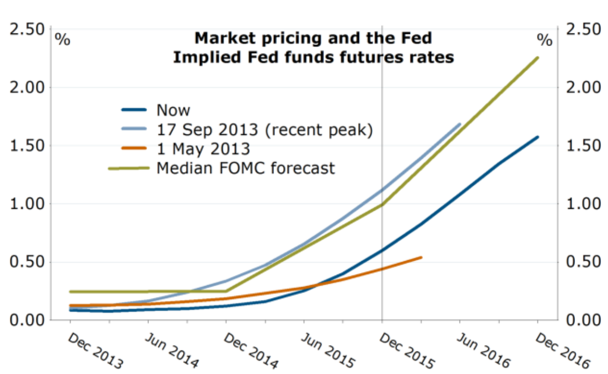
We still expect a pick-up in wage increases later this year to be the trigger for markets to start pricing in significantly more Fed tightening, see Insights: US labour market tighter than people think. For more analysis on why we don't believe in secular stagnation in the US, see Insights: The secular bond bull market will not return.

Shrinking the Fed's balance sheet

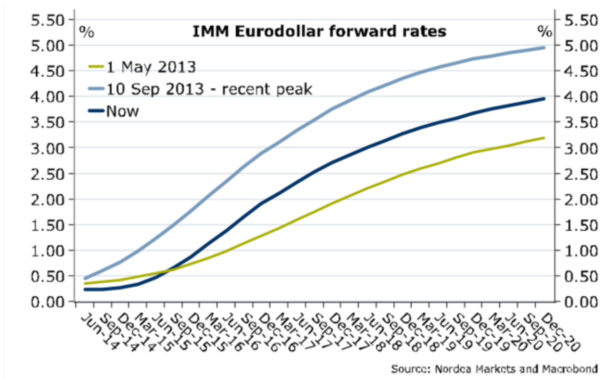
Fed officials are currently revising its first exit strategy, i.e. the sequence and technical details of how tightening will eventually proceed, which was laid out in 2011.

Based on recent statements the revised plan, which probably will be released in a few months, will likely repeat that changes to short-term rates will be

Markets price in a fed funds rate *below* the FOMC's dovish forecast



Markets: Fed will not push rates to 4% until 2020



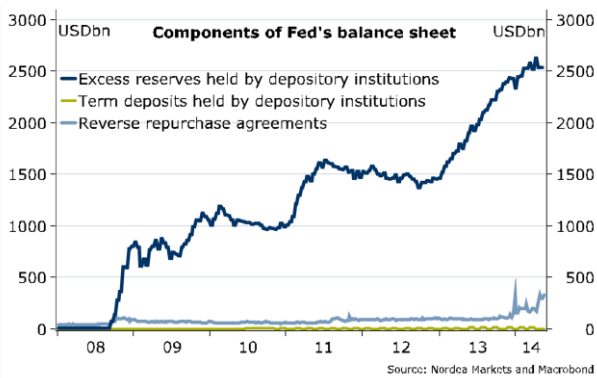
the primary means for adjusting monetary policy post lift-off, not discretionary shifts in the Fed's balance sheet. In other words, the balance sheet will be set on automatic pilot.

Here is our expectation for the Fed's eventual exit from its current policy:

- QE ends in Q4 2014.
- Increased reserve draining operations through reverse repos and term deposits in late 2014/early 2015. Along with the Fed's ability to pay interest on excess reserves the new overnight fixed-rate reverse repo facility should allow the Fed to control short-term money market rates despite operating with a huge balance sheet. As a result, the Fed could move to a floor system. (Under the reverse repo facility the Fed posts a fixed interest rate and accepts cash from counterparties on an overnight basis in return for security).
- The first rate hike is seen in Q1 2015.
- Later in 2015 after the first rate hike, the Fed ceases reinvesting payments of principal on its security holdings. In other words, Fed balance sheet shrinkage starts, with a passive portfolio run-off strategy (maturing assets or prepayments). However, there is almost no natural run-off until early 2016 as essentially all Fed holdings with maturities less than three years were sold under Operation Twist in 2012.
- Outright sales of Treasury and mortgage-backed securities will probably not occur for a period of years after the first rate hike.

We have little doubt that the Fed's exit strategy will come much more into focus over the coming months.

So far only little sterilisation of excess reserves



Maturity distribution of the Fed's security holdings

Remaining maturity	US Treasury securities		Federal agency debt securities		Mortgage-backed securities		Total	
	USDbn	%	USDbn	%	USDbn	%	USDbn	%
<16 days	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16-90 days	0.0	0.0	2.5	5.7	0.0	0.0	2.6	0.1
91 days - 1 year	2.0	0.1	5.7	12.9	0.0	0.0	7.7	0.2
1-5 years	908.6	38.4	33.5	76.1	0.0	0.0	942.2	23.2
5-10 years	824.5	34.8	0.0	0.0	3.7	0.2	828.2	20.4
>10 years	632.0	26.7	2.3	5.3	1,652.1	99.8	2,286.5	56.2
Total	2,367.2	100.0	44.1	100.0	1,655.8	100.0	4,067.1	100.0

Source: Nordea Markets and Federal Reserve