A Bold Move: Is Third Time the Charm?

Northern Trust's analysis of the current state of U.S. monetary policy following the Federal Open Market Committee's (FOMC's) September 12-13 meeting.

September 14, 2012

Current Situation - Overview

Investors, worldwide, have been watching Federal Reserve Chairman Ben Bernanke and the Federal Open Market Committee (FOMC) to see how far the committee would go to support a fledgling economic recovery in the United States. During its September 12-13 meeting, the FOMC took bold, albeit somewhat expected, action.

The FOMC agreed to increase policy accommodation to the tune of $40 billion per month – with no end-date identified. In addition, committee members agreed to extend the current target range for the federal funds rate – between 0 and 25 basis points – through mid-2015.

We believe it is important to understand what was said during the September FOMC meeting – and how the committee's actions can affect investors. Our investment and economic experts have reviewed the FOMC meeting minutes and statement in order to provide you with their insights into the potential market implications of the FOMC's current actions.

Insights and Perspective

Yesterday's policy changes discussed among FOMC committee members will have both short- and long-term effects on U.S. and global markets. (For additional Northern Trust commentary, please see the latest *U.S. Economic & Interest Rate Outlook* from Northern Trust Chief Economist, Carl Tannenbaum, "Open-Ended Easing.")

On the heels of Bernanke's prepared remarks at the Federal Reserve Bank of Kansas City's annual policy conference in Jackson Hole, Wyoming, members of the FOMC decided to expand their current policy of accommodation in order to promote a robust, sustainable economic recovery. The FOMC's decision confirmed our long-held belief that the Fed is more concerned about a tepid economic recovery and disappointing employment growth rather than the potential risk of inflation or unintended consequences in the global capital markets.

While these moves were highly anticipated among industry analysts, we believe the size and scope of the accommodations underscore the depth of the committee's concerns and make this a bold move.

What They Said

Below we've highlighted key decisions and remarks from Bernanke and his fellow committee members:

- **Labor Market Concerns Persist.** Citing their "grave concern" over a stagnated labor market and acknowledging the daunting economic challenges in the United States, the FOMC embraced a mix of traditional and non-traditional monetary policies that includes another round of quantitative easing in the form of large-scale asset purchases. This is, quite possibly, the first time the Fed has so directly tied monetary policy to jobs.

- **Quantitative Easing (QE), Round 3.** To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the FOMC agreed to immediately purchase $40 billion per month of agency mortgage-backed securities (MBS).

  And, the bold move? The FOMC kept this increase in accommodation open-ended.

  Committee members specifically mentioned that they were prepared to continue purchasing agency MBS until the outlook for the labor market improved. The new MBS program, in addition to the reinvestment of principal paydowns, implies that the Federal Reserve *will purchase around $85 billion per month in MBS securities.* In a bit of a surprise to the markets, the FOMC will keep its purchases confined to MBS securities and will not purchase additional Treasuries beyond those being purchased as part of Operation Twist.

- **Held the Line on Rates.** Consistent with Bernanke's remarks leading up to the September 2012 FOMC meeting, the committee members decided to keep the target rate for the federal funds rate at 0 to 25 basis points – and they acknowledged their desire to see continued progress toward maximum employment within the context of price stability. The FOMC pushed out its guidance on the federal funds rate from late-2014 to at least mid-2015.

  This change was consistent with market expectations going into the meeting, yet the new twist is this: the committee highlighted that it was appropriate to keep this accommodative policy stance for a considerable time after they witness a strengthening in the economic recovery. To keep the significance of this open-ended policy change in context, let's remember that the Federal Reserve originally lowered the federal funds rate to 0 to 0.25% in December 2008.

- **Poised to Act.** Another interesting addition to the September 2012 minutes is that the FOMC declared they will stand ready to undertake additional asset purchases and employ other policy tools, as appropriate, until improvement in the labor market is achieved.

For our recent analysis of additional monetary policy tools, please refer to our commentary, "Coming Out of Jackson Hole."

What It All Means for Investors

The FOMC's actions mark a renewed commitment by the Fed to generate a sustained improvement in employment. In comparison, previous Fed actions appear to have been one-off attempts to nudge the economy back on track when growth faltered. This week's actions are different in that the Fed appears to have embraced a continuous accommodative policy moving forward, one that is open-ended and conditional on an improvement in employment.

In light of the FOMC's announcement, we believe investors should keep in mind:

- **Commitment Crosses Borders.** Investors need to remember the Fed is not acting alone. Central banks, worldwide, have been deploying various forms of stimulus measures since the global financial crisis. The European Central Bank's (ECB) recent commitment to do "whatever it takes" and the Chinese government's announcement of a major infrastructure spend show that major policy makers around the world are committed to fostering economic recovery.

- **The Search for Yield Continues.** The cost of low-risk liquidity will remain high for a long period. As the Fed encourages a recovery in housing, it will also encourage investors to seek higher returning assets for higher risks. We believe yield curves will steepen initially, as recent market actions show, but the rise in long rates will be capped by the reality of a Fed on hold for three years. Few trades are more painful in the markets than being short a steep yield curve with no imminent prospects of a rate hike.

Real assets provide the best portfolio protection against inflation, helping to preserve investor purchasing power. But are the old strategies the best strategies?

Northern Trust's Chief Investment Strategist, Jim McDonald, subjects theoretical strategies to real-world tests in his market commentary, ***New Tips on Real Assets***

- **Actions Can Bring Unintended Consequences.** Inevitably, these actions will have both intended and unintended consequences. The "search for yield" will continue in the United States – and around the world – as markets realize cash returns effectively will be zero for another three years. The demand for alternative sources of yield in areas such as high yield bonds and high-quality dividend stocks will continue. While we believe inflation risks will be muted in the near term, real assets providing protection against longer-term inflation risks will see renewed demand. This bodes well for real estate, commodities and natural resource companies. The renewed focus on inflation will also benefit TIPs.

- **Gold's Popularity Persists.** The dollar has now weakened over six percent in just the two months leading up to the September FOMC meeting as anticipation around QE3 built and has been realized. Gold as an alternative currency, which cannot be debased by any central bank, will find new advocates.

For More Information

To access our most recent written commentaries and video podcasts from our experts, we encourage you to visit **northerntrust.com/investmentstrategy**. If you have any questions or would like to learn more regarding how the current state of U.S. monetary policy may affect your portfolio, please contact your relationship manager.