Coming Out of Jackson Hole …

Northern Trust's analysis of the current state of U.S. monetary policy following U.S. Federal Reserve Chairman Ben Bernanke's speech in Jackson Hole, Wyoming.

September 4, 2012

Current Situation - Overview

U.S. Federal Reserve Chairman Ben Bernanke spoke at the Federal Reserve Bank of Kansas City's annual policy conference in Jackson Hole, Wyoming (August 30-September 1, 2012). In the past, the Fed chairman has used this meeting as a platform to discuss policy actions currently under consideration by the Federal Open Market Committee (FOMC) – and this year's meeting was no exception.

Just as Northern Trust Chief Economist Carl Tannenbaum outlined in his Daily Economic Commentary ("The Message From Jackson Hole," August 31, 2012), Bernanke addressed a number of key themes during his prepared remarks. Specifically, Bernanke acknowledged that while the Fed's current nontraditional monetary policy has had a positive effect, weak labor market performance and headwinds from housing, the U.S. fiscal situation and Europe combine to suggest that additional accommodation may be necessary. Many market analysts take this as a clear sign that Bernanke and other members of the FOMC may be open to additional quantitative easing.

Our investment and economic experts have reviewed Bernanke's remarks and have provided their insights into the potential market implications of the actions he and the FOMC may take in the near future.

Insights and Perspective

While it is impossible to predict the future, we believe the potential policy changes highlighted by Bernanke – as well as additional actions the FOMC may take in the future – could have both short- and long-term effects on U.S. and global markets.

How the Fed May Act or React

The possibility remains that the FOMC may elect to take no immediate action at the September meeting, despite the tone of Bernanke's comments at Jackson Hole. That is, the FOMC could decide to continue monitoring incoming economic data to detect signs of strength or weakness before committing to a course of action, but we don't believe this is the most likely outcome. Below we've highlighted some decision scenarios and our view of the potential market implications that could arise, beginning with the scenarios we believe are most likely to occur:

- **Scenario #1: Expand stimulus efforts. The Fed decides to expand its stimulus efforts and launches its third round of Quantitative Easing (QE).**

  Following Bernanke's Jackson Hole speech, this scenario seems increasingly likely.

Citing his “grave concern” over a stagnated labor market and acknowledging the daunting economic challenges facing our nation, Bernanke appeared to open the door to a mix of traditional and non-traditional monetary policies that could include another round of quantitative easing in the form of large-scale asset purchases. While it is unclear when, or if, the FOMC will pursue this particular approach, conventional wisdom suggests another round of quantitative easing, commonly referred to as QE3, may be the hot topic of debate at the FOMC’s September meeting.

Quantitative easing is nothing new to Bernanke and the Fed. The first two rounds of quantitative easing, which are commonly referred to as QE1 and QE2, occurred in November 2008 and March 2009 (QE1) and again in November 2010 (QE2). During QE1, the Fed purchased agencies and mortgage backed securities (MBS) in 2008 and then expanded the program in March 2009, increasing the MBS buying program to $1.25 trillion and purchasing up to $300 billion of Treasuries. Due to ongoing economic weakness and uncertainty, the Fed announced QE2 in November 2010 and purchased an additional $600 billion of long-term Treasuries. Since then, the Fed has rolled out two versions of its “Operation Twist” program, which looks to extend the average maturity of Fed holdings by purchasing long-term Treasuries and selling an equal amount of short-term Treasuries. (For more information about past quantitative easing efforts, Operation Twist – and the equity markets’ reactions – please see the August 31 commentary from Northern Trust Chief Economist Carl Tannenbaum, “[The Message from Jackson Hole](#).”)

Examining the FOMC’s July 31-August 1 meeting minutes, we see that many committee members have indicated that a large-scale asset purchase program could provide additional support for the economic recovery. The argument in favor of such a program points to the expectation that additional quantitative easing would put downward pressure on longer-term interest rates and contribute to easier financial conditions more broadly.

Our View on Implications: Chairman Bernanke’s recent comments, coupled with FOMC minutes from the July 31-August 1 meeting, clearly show that another round of quantitative easing is top-of-mind among committee members. Most market analysts expect that if the Fed does, indeed, embark on QE3, the program would include a preference toward MBS securities – and possibly Treasury securities. During the most recent FOMC meeting, the Fed’s staff prepared and presented an analysis showing substantial capacity for additional purchases without disrupting market functioning, and Bernanke further bolstered the case for non-traditional policies (such as large-scale asset purchases) by declaring the costs of these policies “…when considered carefully, appear manageable, implying that we should not rule out the further use of such policies if economic conditions warrant.”

It will be interesting to see how large the next round of QE might be – and even more interesting to see if the Fed agrees to an additional round of purchases without announcing a cap to the program.

- **<u>Scenario #2:</u> <u>Hold the line on rates and provide greater clarity.</u> The FOMC holds steady on rates. The committee could also extend its current federal funds rate projection into 2015 and/or add a statement indicating what specific economic conditions may warrant a change.**

  While Bernanke's remarks on August 31, 2012, addressed some of the positive economic signs, he clearly stated the "… economic situation is obviously far from satisfactory." This is consistent with the most recent assessment by the FOMC. According to the minutes from the July 31-August 1, 2012 FOMC meeting, the committee members decided to keep the target rate for the federal funds rate at 0 to 0.25% – and they anticipate that economic conditions will likely warrant exceptionally low levels for the federal funds rate at least through late 2014.

  The minutes also show that participants discussed a number of policy tools that the Committee might employ if it decides to provide additional monetary accommodation to support a stronger economic recovery in the context of price stability.

  Committee members noted that an extension of the language (i.e., beyond "late-2014") might be particularly effective if done in conjunction with a statement indicating that a highly accommodative stance of monetary policy was likely to be maintained even as the recovery progressed. However, some committee members questioned whether the forward guidance (currently focused on a specific date) was clear enough. As such, they suggested the Committee should consider refocusing their guidance on economic factors that the Committee would consider when deciding to raise its target for the federal funds rate. Committee members also discussed omitting the forward guidance language entirely.

  If the Federal Reserve were to travel down this path, you might expect them to officially target an economic number, such as the unemployment rate or Nominal GDP. But, in doing so, the FOMC would be committing to keep the federal funds rate at these exceptionally low levels as long as the current economic readings were below their targeted level. For example, the FOMC might indicate that they would keep rates where they are as long as the unemployment rate exceeded 7%, or as long as inflation remained below their preferred 2% target. In addition, the FOMC might target nominal GDP and announce that they were prepared to keep the federal funds rate at current levels as nominal GDP remained lower than its pre-crisis trajectory.

  <u>Our View on Implications:</u> If the FOMC were to continue down this path of "holding the line" and extending its projection, it would in effect signal to the markets that the committee members were prepared to keep the federal funds rate at the current level until a new date. This would not surprise most investors, as the markets are currently expecting that this is among the likeliest options the

Federal Reserve will pursue.

With an extended projection by the FOMC, we would expect to see the short-end of the fixed income rates continue to remain flat and in the 0 to 25 basis point range.

While we believe outlining the conditions for an eventual rise in the fed funds rate is an interesting option that would provide investors with greater clarity around future changes to the Fed's policy on rates, the potential for investor concern persists. By focusing metrics for future action on key economic indicators – rather than on a firm end-date – we believe a sudden move in one of the identified indicators could spur investors to react and, ultimately, force the Fed into action.

Digging Deeper Into the Fed's Toolbox – Other Possible Actions and Outcomes

In the coming days and weeks, a number of economic data releases could provide the FOMC with more facts for consideration. While we believe the first two scenarios we've outlined are the most likely actions we'll see come out of the remaining 2012 FOMC meetings, the Fed does have a number of monetary policy tools at its disposal. As committee members continue to monitor the situation, it is possible they will draw upon the additional scenarios we've outlined below – as well as a combination of any and all of the scenarios we've outlined in this commentary.

- **Scenario #3: Take a Page from the European Central Bank (ECB) Playbook. The FOMC reduces the interest rate paid on required and excess reserve balances (IOER).**

  The Emergency Economic Stabilization Act of 2008 granted the Federal Reserve effective authority to pay interest on balances held by or on behalf of depository institutions at Reserve Banks. The Fed currently pays a rate of 25 basis points on required and excess reserve balances. On its own website, the Fed states it pays interest on reserves in order to "help to establish a lower bound on the federal funds rate by lessening the incentive for institutions to trade balances in the market at rates much below the rate paid on excess balances. Paying interest on excess balances will permit the Federal Reserve to provide sufficient liquidity to support financial stability while implementing the monetary policy that is appropriate in light of the System's macroeconomic objectives of maximum employment and price stability."

  Our View on Implications: While this scenario is definitely within the realm of possibilities, we are not convinced the FOMC is ready to follow the ECB game plan. The markets have been closely monitoring this idea of lowering the IOER since July 5, 2012, when the ECB announced its decision to lower their deposit rate facility from 25 basis points to 0 basis points. As a result of the ECB's actions, the European money market industry was faced with the likelihood of investments in the short end of the market registering zero returns, if not negative. The FOMC indicated in their minutes from the July 31- August 1, 2012 meeting that the ECB's recent deposit rate cut to zero provided an opportunity to learn more about the possible consequences for market functioning in such a move. For example, the $2.6 trillion money market fund industry would experience the adverse effects associated with rates at or below zero in the United States. Bank deposits would experience similar challenges. All of this would, of course, translate to zero, or even negative, returns for investors.

This begs the question: Are investors really willing to accept negative returns on their cash investments? Most industry experts would expect investors to answer with a resounding "no."

Given the systemic importance of money market funds and bank deposits, this scenario could have additional unintended consequences for the financial industry – and for the broader population as a whole. As such, the FOMC may choose to leave the IOER alone, or merely reduce it by a modest degree, for now.

- **Scenario #4: Initiate a new program. The Fed announces an innovative new program aimed at encouraging bank lending.**

  The Federal Reserve has previously indicated that it is exploring new tools to provide further stimulus to the economy. Following the Bank of England's Funding for Lending Scheme, the FOMC is exploring ways to continue to encourage bank lending to households and small firms. Under this approach, the Fed might makes loans through their discount window directly to banks if those banks make new business or consumer loans.

  Our View on Implications: Because the details and scope of such a scenario are still evolving, it is difficult to anticipate all potential implications. However, broadly speaking, this measure would allow the Fed to target lending via consumer and business loans. Those consumers and businesses that had difficulty receiving loans due to tighter lending standards would benefit if this channel were opened.

A Look Ahead

We will be monitoring related developments – including the next meeting of the FOMC on September 12-13 – and will provide you with our insights and perspective shortly after the meeting.

In addition, we encourage you to join us for our next client call on September 18, 2012. Northern Trust's investment and economic experts will be available to review recent actions and answer your questions. For more details, please contact your Northern Trust representative.

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