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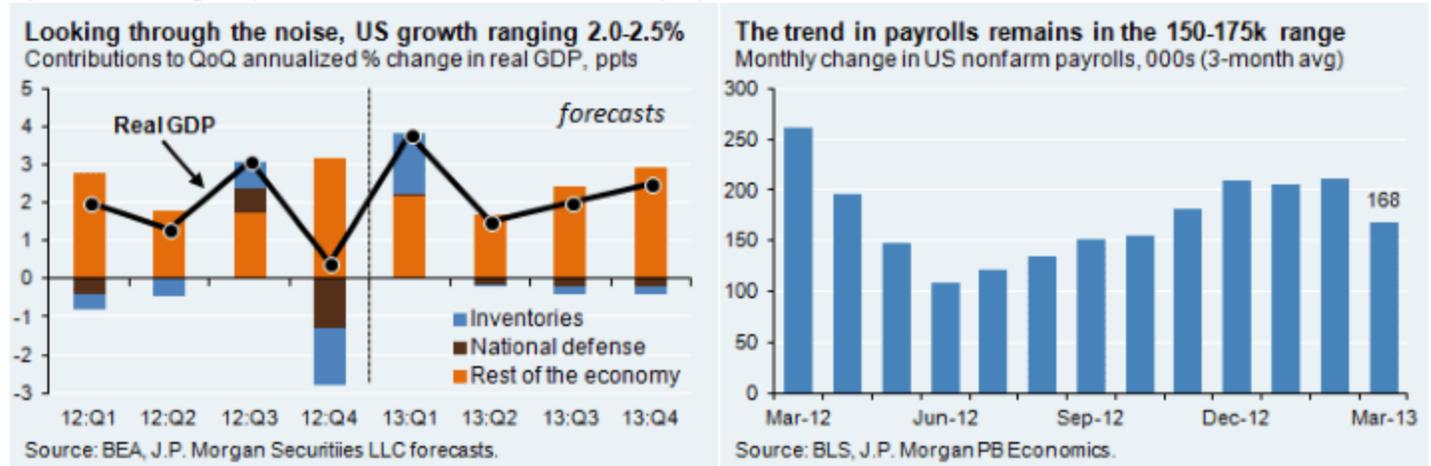
Macro Skinny

J.P.Morgan

April 9, 2013

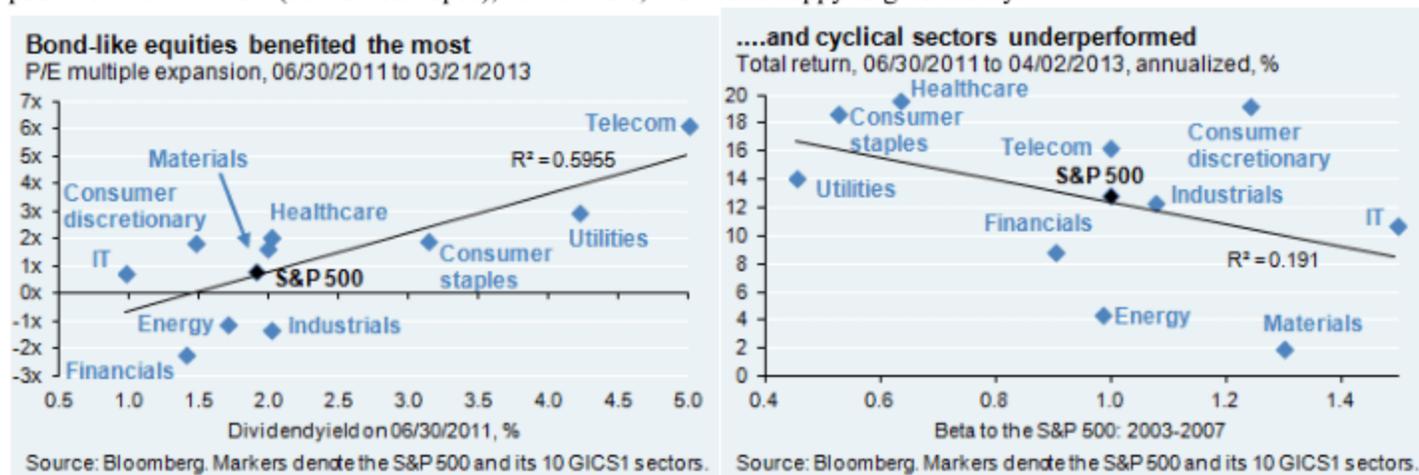
The S&P as a policy tool, revisited

Fiscal drag: it's here, but not here to stay. With all of the uncertainty surrounding the fiscal cliff last year, no one thought first quarter growth in the US would exceed 3%. It's now quite likely, but context is critical. Growth in the fourth quarter was dragged down by a sharp inventory de-stocking and a sudden drop in defense spending (both could be related to the fiscal cliff). The rebound in Q1 hence reflects a one-time positive payback. The story is different for Q2: it is broadly anticipated that the drag from the payroll tax and sequester will finally take effect and push sequential growth to below 2% (weaker growth signs are already seen in the March data). However, looking to the second half of the year, the fiscal drag should fade and growth will likely gradually accelerate. Excluding the inventory noise, the underlying growth picture looks more like 2-2.5% for 2013, better than the 1.5-2.0% we penciled coming into the year. The weak March jobs report tells us the labor market will likely see a bumpy ride as well. Only 88k jobs were added in March, but the trend is still within our expectations of 150-175k per month this year (right chart). Put in the context of healthy hiring months recently and tightened fiscal policy, the broader trend is still encouraging.

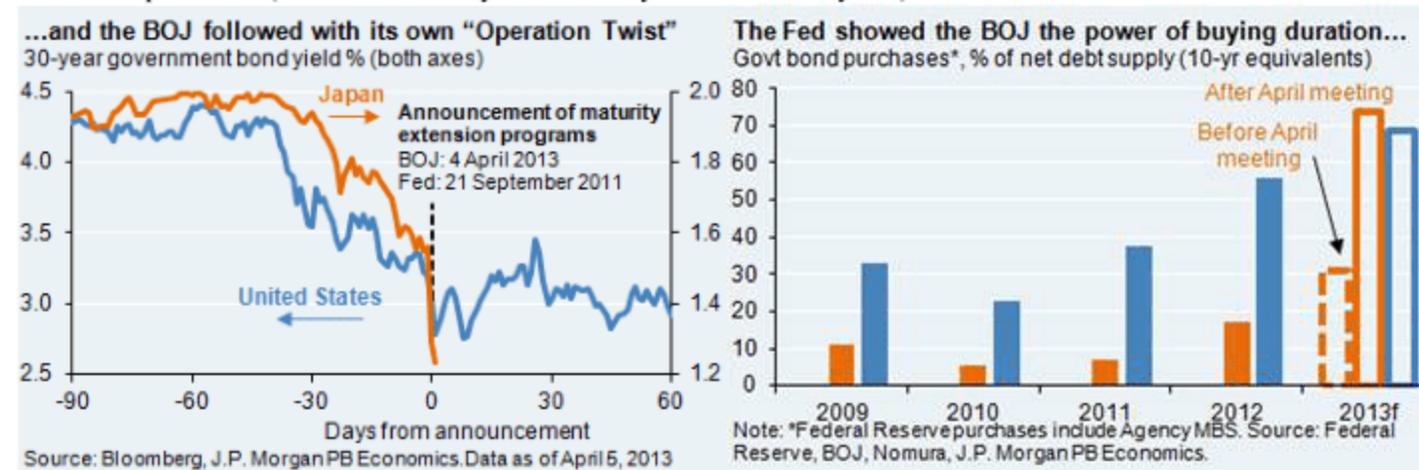


Last summer the Fed signaled its intention to take wealth effects more seriously (See *Macro Skinny*: “Fed policy: carry today, growth tomorrow” and “When the S&P becomes a policy tool”). Since then, stocks have rallied hard with the S&P 500 recently touching a new record. The Fed appears to have had more influence than the gradual growth rebound. Indeed, stock returns were strikingly correlated with dividend yields; translation: *bond-like* stocks have generally done better than growth stocks (charts below). This unusual phenomenon was not seen during QE1/QE2; rather it started when the Fed shifted its asset purchases towards long-term securities. This aggressive duration buying policy nudged the traditional holders of long-term securities to sell them at low yields (great profits) and look for a source of cash flow elsewhere.¹ As for investors overweight cash, rebuilding risk has typically started in US Treasuries, but not this time given how flat the yield curve is. They too, are nudged to head straight for riskier assets. Chairman Bernanke reiterated following

the March meeting that the Fed does not target higher stock prices, although he conceded in the past that asset prices may compensate for the fact that zero rates are not accommodative enough.² Time will tell whether higher asset prices trigger positive wealth effects (as the Fed hopes), but for now, the Fed is happy to give it a try.

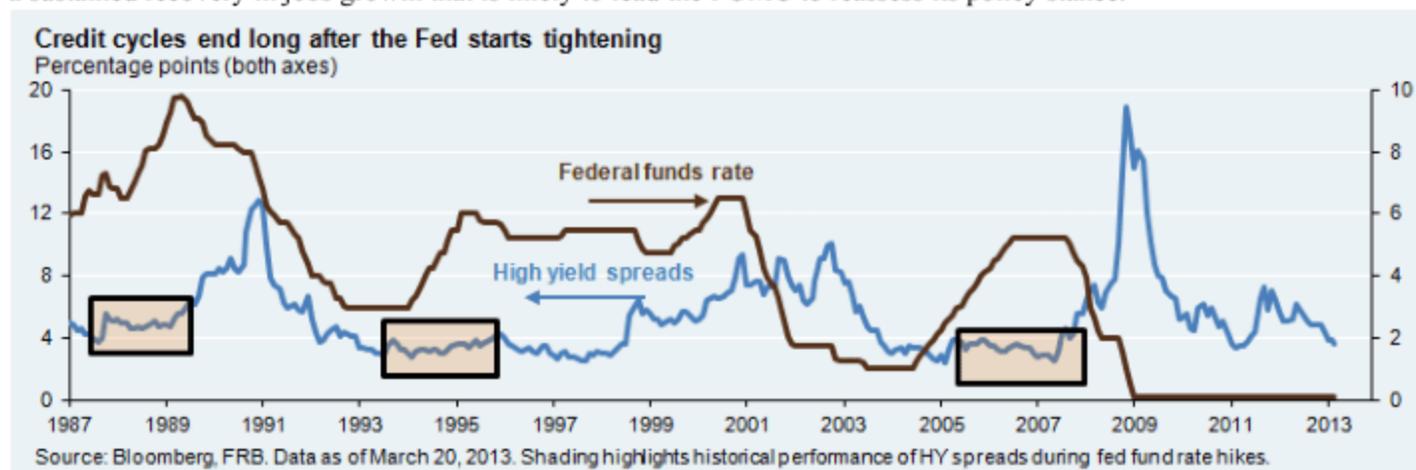


At the heart of these policy initiatives is the notion that, compared to past cycles, the recent recession has inflicted much more damage on the labor market. The implication is that there is a lot of room for growth in employment and the broader economy before inflation becomes a real issue. Crucially, this means that monetary policy will stay unusually loose for an extended period, as the economy gradually recovers. To be clear, the Fed hinted in January that it may stop purchasing securities by year-end or early next year. But like the last part of every fireworks show, the Fed QE program is ending with a big bang; this year, the Fed will be buying an estimated 70% of the net duration supply from the Treasury and Agency MBS market (!). Moreover, the end of Fed bond-buying, which is likely next year, doesn't imply a start to active bond-selling. Rather, the next move from the Fed is likely to be policy rate hiking (not before late-2015 in our view), while holding its existing securities until maturity.³ This means that the exit will be smoothed over a very long period (beyond 2020). If the Fed can clearly communicate its pace of policy firming and resolve any confusion around the mechanisms it will use to drain liquidity, this kind of gradual exit should not trigger a violent move in the bond market.⁴ The central bank liquidity surge is not limited to the Fed: the BoE has taken a similar path, and the BoJ, under its new leader Kuroda, just embarked on a grand beginning (in its long-standing battle with deflation). Taking a page from the Fed's book, the BOJ is now focused on scooping long-dated securities from the market and will be significantly extending the average maturity of the JGBs it purchases (from under three years currently to about seven years).

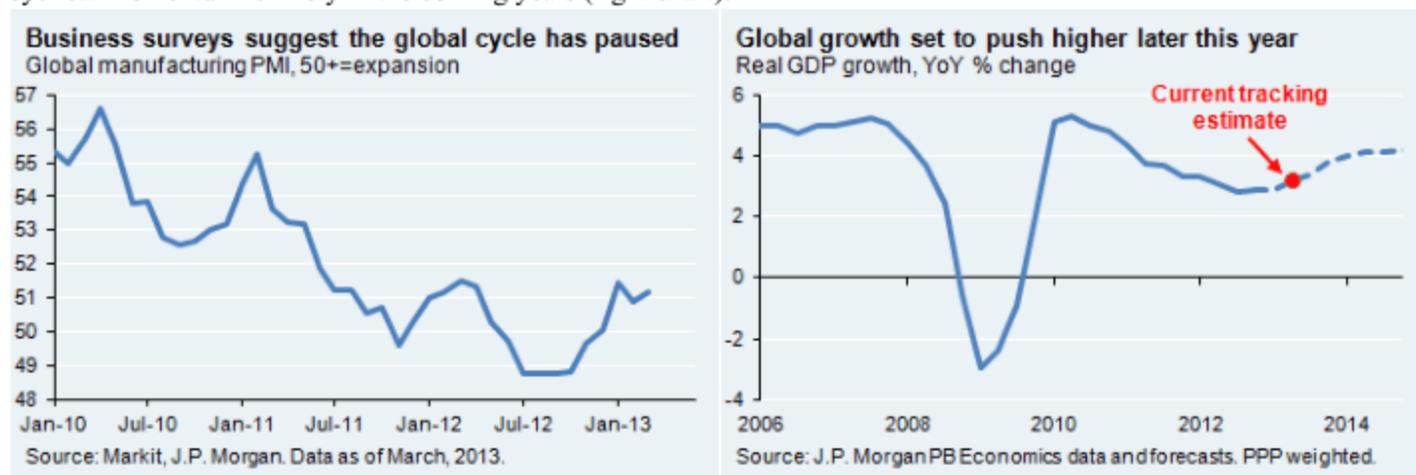


If there is a near-term threat for the bond market, it is that Fed tightening could happen sooner and at a faster pace than currently anticipated. This would arise from either growth surprising significantly on the upside or from inflation (and inflation expectations) rising sharply. But in past cycles, higher yields and the start of a Fed rate cycle, especially when driven by stronger growth, have not signaled the turning point in risk markets. For instance, credit spreads—a good barometer for risk appetite—remained tight long after rates rose (chart below). A challenging and more dangerous scenario, albeit a less likely one, is if yields were to pick up in response to mounting supply-side inflation instead of growth. The unexpected recent decline in the unemployment rate, despite relatively anemic growth in output and jobs, may worry markets in this regard. Yet, we see the decline in the unemployment rate as a technical move.⁵ Bernanke thinks so, too. The FOMC did explicitly tie the timing of the first rate hike to unemployment in December 2012 (vowing to keep rates low as long as the unemployment rate exceeds 6.5% and inflation risks are muted). Further declines in the unemployment rate, if

driven by technical and not economic factors, might muddle the Fed's message but won't force them to tighten policy. Mr. Bernanke made it clear that the unemployment rate informs their rate decisions but it's by no means a *trigger*.⁶ Rather, it is a sustained recovery in jobs growth that is likely to lead the FOMC to reassess its policy stance.



Aside from the monetary engine, the growth engine will remain supportive in the coming years. But as we argued in recent publications (See *Macro Skinny*: “Stabilizing at healthy levels” and “A good start to the New Year”), the global cycle has been set to pause at healthy levels in the next couple of quarters (after an impressive run-up in growth momentum since last summer), before it reaccelerates later in the year. The global PMI rose slightly in March and was supported by improvements in the US and China (left chart). This strength was offset by surveys in the Eurozone, where manufacturing activity appears to have slowed further. Despite this weakness, growth momentum in Europe is still tracking above the pre-OMT lows from last July, and remains consistent with our expectation that growth in the region will turn positive in the second half of this year. Zooming out, we still strongly feel that the world economy is in the midst of a broader cyclical recovery. We won't go back to the hey-days of 2005-2007 where world growth was tracking at 5%, but certainly more cyclical momentum is likely in the coming years (right chart).



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[1] A preferred substitute for many investors who sold these bonds appears to have been dividend stocks: they provide a long stream of cash flow at a relatively attractive yield, offer upside of capital appreciation, and provide a better hedge against inflation.
 [2] Chairman Bernanke made this justification for QE2 in a 3 November 2010 [Washington Post op-ed](#): “[QE] eased financial conditions in the past and, so far, looks to be effective again. **Stock prices rose** and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. **And**

higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion” (emphasis added).

[3] We know from discussions around the exit strategy in summer 2011 and Chairman Bernanke has since confirmed that asset sales wouldn’t happen until *at least a year* after the first rate hike. FOMC participants are currently reassessing their exit strategy views and it’s likely we’ll have more clarity in the coming months. One potential, and increasingly likely, outcome is the Fed decides it will never actively unwind its portfolio. It’s important to keep in mind that most FOMC participants are confident that, when it’s time to tighten, the target rate (not the balance sheet) is the way to do that. The authors of a [recent Fed paper](#) found that asset sales would lead the Fed to realize more potential losses rather than just holding everything to maturity. This assessment – along with the view that selling assets might “destabilize markets” – has led some FOMC members, such as Jerome Powell, to push for a “not for sale” assignment to the assets.

[4] The expectations that the exit won’t be violent for the bond market makes sense given that the Fed is not selling long-term maturity bonds anytime soon and given that the only other major players in this high-duration markets are those who are mandated to own duration, such as pension funds and life insurers. This is consistent with our Treasury valuation models, which accounts for the zero bound in Fed Funds and the shift to QE territory. Absent a sharp unwind of the Fed’s balance sheet, these models estimate a very gradual pick-up in yields—broadly in line with the forwards.

[5] Recent declines in the unemployment rate have been driven by a collapse in labor force participation. Our models suggest that as the US recovery continues the cyclical decline in participation should slow, if not reverse. This means further declines in the unemployment rate from here should be more challenging.

[6] He also noted all of the other labor market indicators he’s watching in his Wednesday, March 20th press conference: “I would say that we will be looking for sustained improvement in a range of key labor market indicators, including obviously, payrolls, unemployment rate, but also others like the hiring rate, claims for unemployment insurance, quit rates, wage rates and so on, looking for sustained improvement across a range of indicators, and in a way that is taking place throughout the economy.”

Acronyms:

BEA – Bureau of Economic Analysis

BoE – Bank of England

BoJ – Bank of Japan

BLS – Bureau of Labor Statistics

FOMC – Federal Open Market Committee

FRB – Federal Reserve Board

GICS – Global Industry Classification Standard

HY – High Yield

MBS – Mortgage Backed Securities

OMT – Outright Monetary Transactions

PMI – Purchasing Managers Index

S&P – Standard & Poor’s 500 Index – a value-weighted equity index of 500 large US companies

QE – Quantitative Easing

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