Weekly Economic Commentary

January 27, 2014

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Time to Hit the Pause Button?

This week (January 27–31, 2014) the Federal Reserve's (Fed) policymaking arm, the Federal Open Market Committee (FOMC), holds the first of its eight meetings this year. The meeting—which will conclude with the FOMC issuing a statement at 2PM ET on Wednesday, January 29—is being held against the backdrop of a wave of volatility in global financial markets, as market participants brace for another round of tapering by the FOMC.

We—and the consensus of economists as polled by Bloomberg News—expect that the FOMC will vote to taper its purchases of Treasury notes and mortgage-backed securities (MBS) by $10 billion per month. Currently, the Fed is purchasing $75 billion in Treasuries and MBS per month as part of its quantitative easing (QE) program. We expect the FOMC to announce this week that it will purchase $65 billion per month until the next FOMC meeting in March 2014. We also expect that the FOMC will continue to taper QE at this pace ($10 billion per meeting) at each of the remaining FOMC meetings this year, which would completely wind down QE by the end of 2014.

Although the market has largely priced in the FOMC's tapering plan, some of the recent volatility in financial markets is likely related to the direct and indirect impact of the Fed's policies on emerging market currencies and economies. In the face of relatively sluggish global demand in recent years, many emerging market countries have relied on the extraordinary liquidity provided by the world's central banks to grow their economies, at the cost of running current account deficits as they increasingly borrow to import more than they export. As global credit conditions tighten (see below for details) and developed market bond yields rise, funding for widening current account deficits becomes scarcer and more costly, putting increasing pressure on these emerging economies. Emerging market currencies are depreciating as investors find more attractive yields in more financially stable markets and central banks start to drain global liquidity.

Highlights

We expect that the FOMC will vote at this week's meeting to further taper its purchases of Treasuries and MBS by $10 billion per month, bringing monthly purchases to $65 billion.

We believe the FOMC will taper QE at a $10 billion pace per meeting this year, and we expect QE to end by the end of 2014.

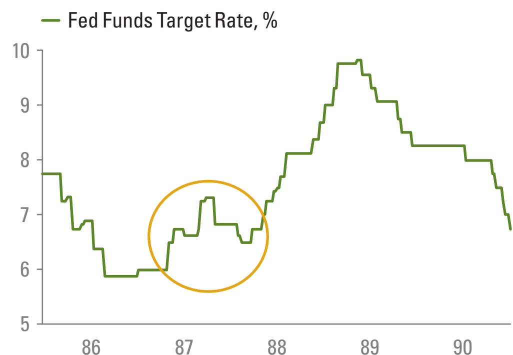
In our view, not enough time has passed since the last meeting for FOMC participants' views of the economy, labor market, and inflation to have changed significantly enough to warrant a pause in tapering.

Potential Market Disruptions

The question financial market participants are asking this week ahead of the meeting: Will the FOMC hit the pause button on tapering because of the uptick in volatility? In our view, the hurdle for the FOMC to suspend tapering for a meeting is relatively high, and as of early Monday, January 27, 2014, that hurdle has not yet been cleared. The longer the financial market

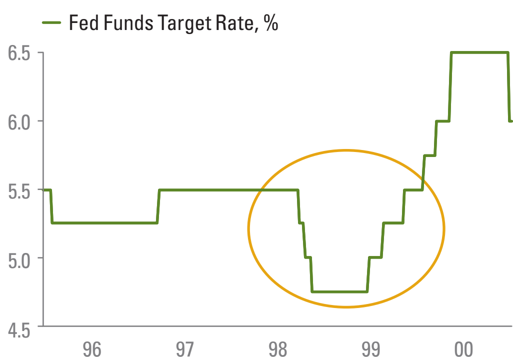
During Prior Periods of Elevated Financial Market Stress, the Fed Has Hit the **Pause Button**

1 1987 Stock Market Crash



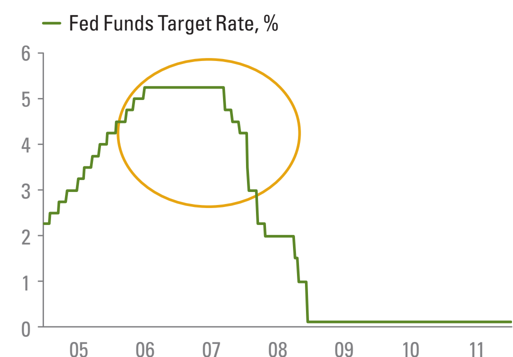
Source: LPL Financial Research, Federal Reserve Board, Haver Analytics 01/24/14

2 1997–1998 Asian Financial Crisis



Source: LPL Financial Research, Federal Reserve Board, Haver Analytics 01/24/14

3 2007 Start of Financial Crisis



Source: LPL Financial Research, Federal Reserve Board, Haver Analytics 01/24/14

Past performance is no guarantee of future results.

disruptions persist ahead of the meeting this week, the more likely it is that the Fed pauses. These potential disruptions include but are not limited to:

- Widening credit spreads on emerging market sovereign debt;
- The disorderly decline in the value of emerging market currencies versus the dollar, euro, and yen;
- The drop in Treasury yields as a result of a "flight to safety;" and
- Sharply decreasing liquidity and trading volumes in emerging market financial instruments.

If the disruptions persist, the FOMC statement will likely at least mention the financial stress in the statement, and note that the Fed is monitoring the situation closely.

Although they have deteriorated over the past week and a half (through Friday, January 24, 2014), the following well-known measures of financial market stress indicate that financial market conditions are in better shape today than they were just before the December 18, 2013 FOMC meeting:

- The Bloomberg Financial Conditions Index;
- The St. Louis Fed Financial Stress Index;
- The Cleveland Fed Financial Stress Index; and
- The Chicago Fed National Financial Conditions Index.

Hitting the Pause Button

During the past quarter century or so, the Fed has hit the pause button in the midst of similar market events on several occasions. For example, in the aftermath of the October 1987 stock market crash, the Fed, which had been raising rates to combat higher inflation and a falling dollar, was quite sensitive to the loss of liquidity and the disorderly financial markets and cut rates for several months in late 1987 and early 1988. The Fed began raising rates again in February 1988 [Figure 1].

In the mid-to-late 1990s, the Fed raised rates (1994–1995), paused, and even cut rates in 1996, but began raising rates again in early 1997. Then, in mid-1997, emerging market economies, which were in far worse shape than they are today (see box on page 3), began experiencing many of the same disruptions that we are seeing now. The Fed didn't raise rates again in 1997. In the summer of 1998, as the Asia financial crisis came to a head, the Fed cut rates three times (by a total of 75 basis points) between September and November 1998, citing "growing caution by lenders and unsettled conditions in financial markets" and "unusual strains" in financial markets. By mid-1999, the Fed had resumed the tightening it began in 1997, and tightened until mid-2000 [Figure 2].

In some cases, the Fed will simply announce—as it did during the liquidity crisis in August 2007—that it is aware of the financial market disruptions and is prepared to act if needed. This seems like the most likely outcome this week, assuming conditions don't deteriorate in a disorderly manner

Emerging Markets Better Positioned Than in 1997

Similar to the environment that preceded the July start of the 1997 Asian financial crisis, U.S. economic growth has prompted the Fed to reduce monetary stimulus. The Fed's tapering draws a comparison to the Fed rate hike of March 1997. During the week of January 20–23, 2014, the market has shown some concern about this week's Fed meeting and the possibility of an increase in the pace of tapering, as well as stronger U.K. and European data and their impact on the European Central Bank (ECB) and the Bank of England. However, unlike 1997, smaller deficits, larger foreign currency reserves, more debt denominated in local currencies, and flexible exchange rates are positives likely to help avoid another emerging market crisis that could spill over to the United States and other developed markets or economies.

early in the week. In August 2007 the FOMC said: "[The FOMC] is providing liquidity to facilitate the orderly functioning of financial markets" because "in current circumstances, depository institutions may experience unusual funding needs because of dislocations in money and credit markets." A month later, the FOMC cut rates, kicking off the now six-and-a-half year old easing cycle [Figure 3].

4 Most of the U.S. Economic Data Released Since the Last FOMC Meeting Has Been Better Than Expected

Source: LPL Financial Research, Citigroup 01/24/14

*A rising line indicates that economic data is beating expectations.

Past performance is no guarantee of future results.

In some cases, the Fed will simply announce—as it did during the liquidity crisis in August 2007—that it is aware of the financial market disruptions and is prepared to act if needed. This seems like the most likely outcome this week, assuming conditions don't deteriorate in a disorderly manner early in the week.

Pause Unlikely

In our view, not enough time has passed since the last meeting for FOMC participants' views of the economy, labor market, and inflation to have changed significantly enough to warrant a pause in tapering. For example, using the Citigroup Economic Surprise Index as a gauge, the economic data released in the United States since the December 17–18 FOMC meeting has exceeded expectations [Figure 4]. In addition, the market's inflation expectations for the next five years have not changed much. Although the December employment report was weaker than expected, other labor market indicators released since the December 2013 FOMC meeting have pointed to an improving labor market. Should global financial market conditions continue to deteriorate early this week, the FOMC will likely at least acknowledge the deterioration in its statement. A sharp and disorderly deterioration in financial market conditions might prompt the FOMC to hit the pause button. Stay tuned. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of U.S. Treasury securities).

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Mortgage-Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

INDEX DESCRIPTIONS

Citigroup Economic Surprise Index (CESI) measures the variation in the gap between the expectations and the real economic data.

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