NEXT EXIT
THE ROAD AHEAD FOR THE FED

OCTOBER 9, 2013

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One US Federal Reserve exit has become clear; the other one is very much up in the air. The first exit is straightforward: Fed Chairman Ben Bernanke, who faced down the biggest financial crisis since the Great Depression, is handing over the reins to his lieutenant Janet Yellen sometime early next year. The second is fiendishly difficult: Yellen has the challenge of exiting an era of ultra-loose monetary policies.

What happens when Yellen takes over?

- The Fed may reduce, or "taper," its $85 billion-a-month bond purchases as early as December—notwithstanding Yellen's dovish reputation. Yet the new chair is likely to give greater weight to the second part of the Fed's dual mandate: full employment (over inflation). This will likely mean "low for longer" interest rates.
- Yellen will probably drop policy hints during her confirmation hearings. Look for pointers on the merits of monthly bond buying versus "forward guidance" (declaring targets and thresholds for the future funds rate); the right way to measure unemployment; the use of "optimal control" (long-term policy planning and commitments); and the pitfalls of basing guidance on recent economic data.
- Another key issue: the pace and communication of tapering. The mere mention of the word tightened monetary conditions—ostensibly more than the Fed expected. It also gave emerging market investors a reality check. The lesson: Fed policy is no panacea for countries dependent on foreign funding.
- Yellen may be more forceful than the consensus-driven Bernanke, but it remains to be seen if her colleagues will go along. An added uncertainty: A majority of voting members of the Federal Open Market Committee (FOMC) is set to change in 2014. Yellen has advocated central bankers do more to spur economic activity. Representing the collective FOMC brain trust, will the new chair have to acknowledge the limits of monetary policy?

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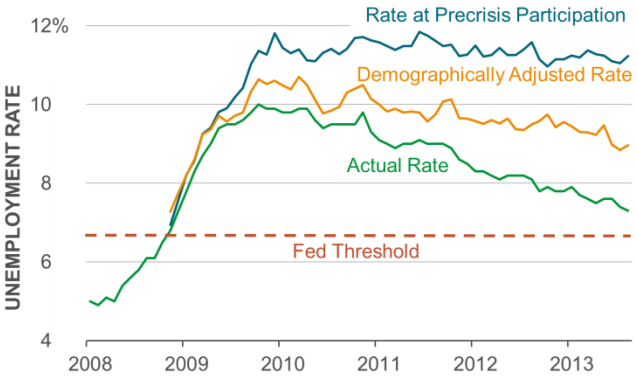
US Unemployment Rate, 2008-2013



Sources: BlackRock Investment Institute, Bureau of Labor Statistics and Bloomberg, September 2013.
Notes: Rate at precrisis participation represents what the jobless rate would have been if the labor force participation rate had held steady at the January 2008 level of 66.2%, versus an actual rate of 63.2% in August 2013. The demographically adjusted unemployment rate is a BlackRock calculation that accounts for the impact of population trends on the participation rate.

SO WHAT DO I DO WITH MY MONEY?®

Wait and See

We are not clairvoyant on the new Fed chair's future moves, and will watch Yellen's confirmation hearings for policy hints. For now, we stick to our overarching themes:

Selective in Stocks

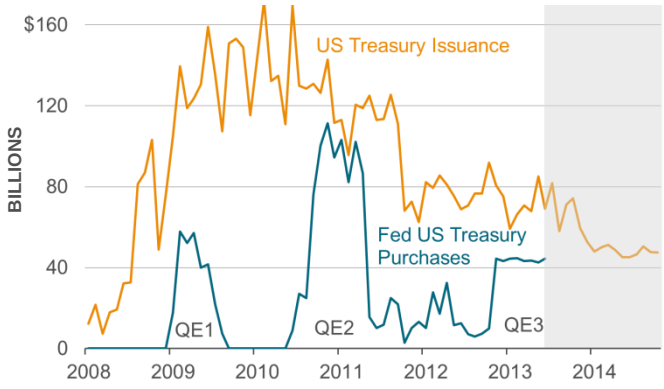
Markets have likely priced in Yellen's appointment. Valuations, earnings, economic momentum and uncertainties such as the US budget battles are likely key drivers in coming months. We favor European and Japanese equities as well as US mega caps.

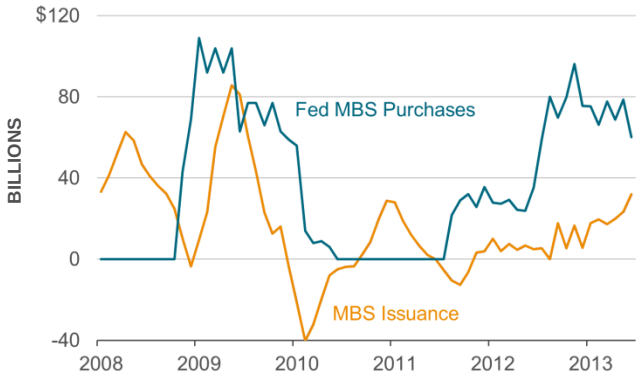
Rethink Fixed Income

Credit (particularly high yield and bank loans) looks more attractive than government debt. The Fed is unlikely to reduce its mortgage buying at more than a snail's pace, underpinning the sector. We prefer an "unconstrained" (non-benchmark) approach amid (slowly) rising yields.

BUYING POWER

US Treasury and Mortgage Issuance vs. Fed Purchases, 2008-2014





Sources: BlackRock Investment Institute and Credit Suisse, September 2013.
Notes: US Treasury and mortgage-backed securities (MBS) issuance data are net and based on three-month moving averages. The shaded area represents Credit Suisse's forecast based on US public deficit projections.

Wanted: Jobs

Markets would probably applaud a clear timetable for the Fed's tapering and rate hikes. Keep hope alive! The Fed has said economic data will drive its actions—and proved the point in September when it unexpectedly kept its bond-buying program intact. Touchstones include the health of the jobs and housing markets. Yet these are not clear-cut.

The Fed has said it would consider raising rates when US unemployment falls below 6.5% (provided inflation stays in check). At the pace of decline from the October 2009 peak, it will hit this target by September 2014. But Yellen has indicated she believes the headline unemployment rate may not be the best gauge of labor market health. Why?

Many workers have given up looking for work while others have retired. If labor participation were at its pre-crisis level, unemployment would be 11% today, rather than 7.3%. See the chart on the previous page. The other side of that argument: The pre-crisis rate was a cyclical high that will not come back any time soon. The Fed will likely debate this issue intensely. Two other signs the unemployment drop may be misleading: anemic income growth and jobless duration running at twice its long-term average.

IN CONTROL

One potential change in a Yellen-led Fed: a shift to "optimal control." This means committing to a long-term policy path that meets the Fed's objectives, rather than revisiting policy based on economic trends at each FOMC meeting. The Fed would stand pat—even if inflation were to tick higher. The benefit? By promising to keep rates low, the Fed could get unemployment to fall more quickly. There is a catch: The approach only works if markets believe the Fed will keep its promise. Optimal control would likely result in a longer period of lower rates—and more rapid rate hikes later. The approach is on the academic cutting edge, but is untested in the real world.

The Fed is likely to go slow in departing from loose monetary policies. This is reflected in its own projections. A solid majority of the FOMC prefers to keep rates on hold until 2015. "Low for longer" is still the mantra. Consider:

- The housing recovery is fragile. Affordability has dropped by 25%, according to the National Association of Realtors. Incomes have not kept pace with rising house prices. Mortgage rates spiked (and applications plunged) after Bernanke first uttered the "taper" word in May.
- Inflation is low—and falling. The Fed's preferred measure, the personal consumption expenditures (PCE) deflator, contracted 0.1% in the second quarter, indicating mild *deflation*, according to the Bureau of Economic Analysis.
- Markets increasingly worry about the US budget showdown. The Fed has warned about Washington's fiscal folly—and tried to mitigate its impact.

A Dominant Buyer

The best argument for tapering sooner rather than later? The Fed is running out of stuff to buy. Economic growth, increased tax revenues and lower spending mean the US government is issuing less debt. If the Fed were to keep buying at the current clip, it would devour almost the entire amount of net US Treasury issuance (issuance less redemptions) in 2014. See the left chart above.

The Fed's dominance of the agency mortgage-backed securities (MBS) market is even more profound. The central bank has been gobbling up more than 100% of net issuance since October 2011, effectively reducing the market's size. See the right chart above. The Fed's holdings have grown to 25% of the market.

Nonetheless, policymakers must tread with care. A reduction in Fed buying could hike mortgage rates and disrupt the housing recovery. This is why we expect the Fed to focus its tapering on US Treasuries.

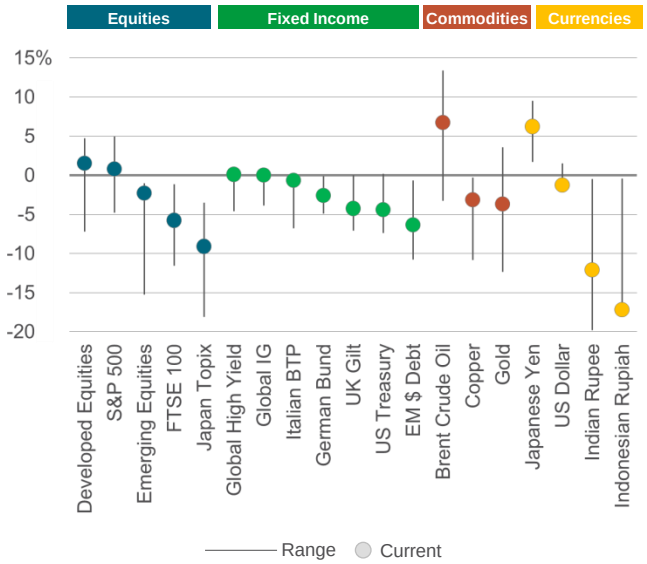
The Great Divergence

The monetary policies of major central banks are starting to diverge. Consider:

- The Bank of Japan (BoJ) is going full steam ahead with its version of quantitative easing (which includes purchases of equity exchange traded funds and real estate investment trusts). The BOJ's balance sheet has swollen to 35% of GDP—almost twice the size of the Fed's stimulus in relation to the size of its economy. See the chart on the right.
- The European Central Bank (ECB) is standing pat for now. Its balance sheet is shrinking as solvent banks pay back long-term refinancing operations (LTRO), the easy cash meant to bring down borrowing costs for troubled banks (and governments). The ECB has flagged the possibility of more LTROs in 2014.
- The Bank of England (BoE) has kept bond buying on hold but promised to keep interest rates low until the UK's unemployment rate falls below 7%. The BoE predicts this will not happen until 2016—but signs of an economic recovery recently led markets to price in a rate hike by as early as late 2014.
- The Fed will soon start to wind down its massive stimulus —albeit at a very modest pace, we expect. This is important: The Fed is the biggest central bank player in absolute dollar terms. Its balance sheet is set to stay large for a very long time. The central bank has vowed to keep reinvesting coupon payments and maturing bonds—even after ending its bond-buying program.

TRACKING THE TAPER TAPE

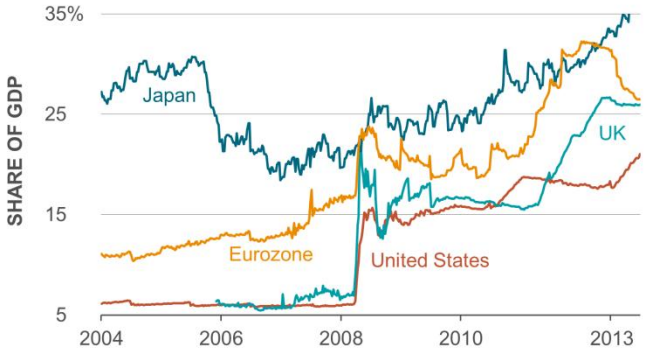
Asset Performance Since Bernanke's Taper Speech



Sources: BlackRock Investment Institute and Thomson Reuters, October 2013.
Notes: Returns for equities and bonds are total returns in local currencies from May 22 to October 8, 2013. Treasuries are 10-year bonds. Commodities and currencies show changes in spot prices.

PARTING WAYS

Central Bank Assets, 2004-2013



Sources: BlackRock Investment Institute, Thomson Reuters, IMF and central banks, September 2013.
Note: Data for 2013 are based on IMF GDP forecasts.

There are common threads, too. Sluggish growth is troubling policymakers. The five-year average of global nominal GDP growth has fallen to its lowest rate since the 1930s, according to Deutsche Bank. Nominal growth matters. (Inflation is low and debts must be repaid in nominal terms.) G7 economies have racked up an extra $18 trillion in public and private sector debt since 2007, Deutsche Bank data show. That is 10 times the size of Canada's economy. So much for the much talked about deleveraging after the financial crisis.

Emerging Effects

Bernanke's mere mention of tapering (on May 22, 2013) hit financial markets hard, as the chart on the left shows. It exposed deep fault lines in many emerging markets. Current account deficits and lofty valuations left some countries exposed to capital flight and currency collapse. Consider:

- Countries most vulnerable to funding pressures include the "fragile five" of Brazil, India, Indonesia, South Africa and Turkey, as well as Eastern European countries such as Ukraine and Hungary. By contrast, China, South Korea and Taiwan look resilient: They have current account surpluses, large foreign reserve buffers and low corporate leverage.
- Emerging markets are currency plays. Some have raised interest rates (think India and Brazil), while others have dipped into foreign exchange war chests to defend their currencies. This has arrested currency declines—for now.
- The Fed's decision to keep the liquidity tap open granted emerging markets a reprieve. Yet fault lines remain. Vulnerable emerging market economies have a window to shore up their defenses before the next storm hits.
- Most central bankers claim domestic mandates and trends drive their policy decisions. A Yellen Fed is more likely than its predecessors to actually implement this. Policy spillovers to emerging markets are unlikely to sway its agenda (unless they hurt the US economy).

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