CAPITAL MARKETS RESEARCH

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Special Update

Fed's Published Rate Forecasts Could Be A Warm-Up To QE3

- **A solid case can be made for the Fed embarking upon another asset expansion program after it experiments with published rate forecasts at the January 25th FOMC meeting.**

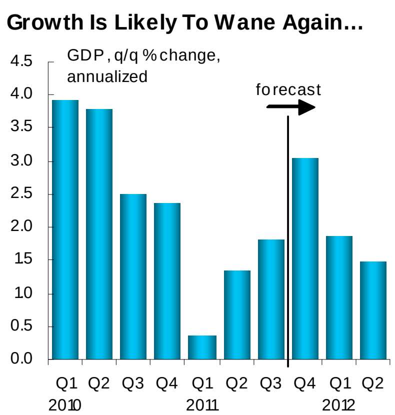
We present arguments for why we think the Fed will embark upon another round of asset purchases by about mid-year that could bring the Fed's balance sheet up to just shy of US$3½ trillion and total reserves to about US$2.1 trillion. We expect this to be comprised of at least a half trillion in additional Treasury and MBS purchases. That, in turn, would be more conducive toward a view that sees the Fed funds target rising by no earlier than market pricing and perhaps beyond mid-2014. We assume a roughly year-long implementation program followed by a year's worth of reinvestment toward a flat Federal Reserve balance sheet and then a move toward stopping coupon reinvestment and a bias shift that ultimately leads toward hikes in the Fed funds target. In what follows we are not saying that this is what we think the Fed should be doing — our regular readers know our stance on this topic — and instead provide arguments for why we think the Fed will embrace QE3. Throughout it all, the wild card may be political risk during a Presidential election year.

1. Growth And Inflation Could Wane By Summer

Going into his Jackson Hole speech in August 2010, Federal Reserve Chairman Ben Bernanke could point to waning growth and inflation as justification for QE2. Presently he faces the opposite circumstances as growth has accelerated to 3% or higher into 2011Q4 while inflation remains relatively high. By mid-year, it may well be that growth will have cooled again to a one-handled q/q pace as per the Scotia Economics forecast. The lagged effects of Europe's troubles will work through credit markets and transmit into the broader US economy. Consumption growth is likely to soften — as it did by year-end 2011 after having been brought forward to 2011H2 likely only temporarily at the expense of the personal saving rate given weak income growth. Business investment was also brought forward into 2011H2 before depreciation incentives expired and face uncertainty in 2012.

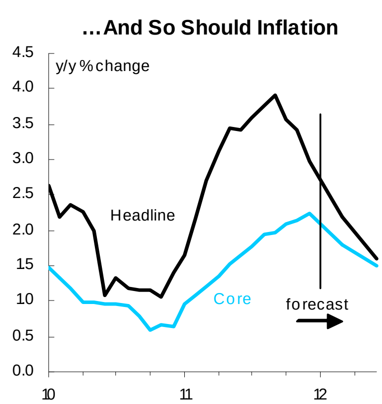
By mid-year, we forecast that inflation will also likely have cooled enough to give the Fed some comfort in easing further. It is already on such a path as headline inflation has moderated sharply via a nearly full percentage point

Chart 1



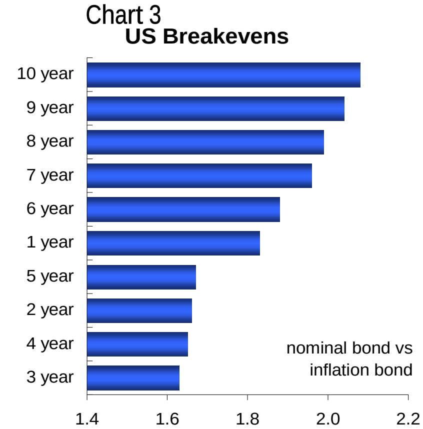
Source: BEA, Scotia Economics.

Chart 2



Source: BLS, Scotia Economics.

Chart 3



Source: Bloomberg, Scotia Economics.

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drop in the yearly rate in just three months from September's 3.9% y/y pace to December's 3.0% reading. We are expecting headline inflation to bottom at 1.5% y/y in 2012Q2 and for the 2013 picture to be in line with a 2% call. Market inflation break-even rates are already generally on that page (chart 3).

Further to this point, it is not difficult to imagine a substantial decline in inflation readings by summer. Should the monthly pace of headline inflation over the next year ride in tandem with the relatively stable monthly averages of the past one, two, three or even five year performance of roughly 0.2% m/m, then headline CPI in y/y terms could bottom even lower than what we are showing in chart 2 and do so into summer.

Combined, this could repeat the picture of cooling inflation and growth (charts 1 and 2) in the lead-up to QE2 which began with Fed Chairman Bernanke's August 2010 Jackson Hole speech. This scenario increases concerns in terms of the Fed's dual mandate.

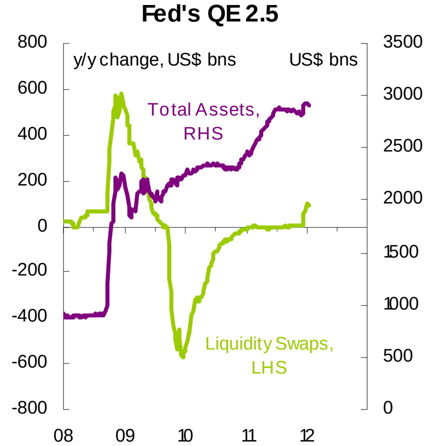
2. Ending Stimulus Mid-Year Is Likely Too Early

Further, it is unlikely that the Fed will wish the effects of its current two forms of stimulus provisions to wane in the fairly near term. One is the Fed's QE2.5, or QE-lite program as represented by the move not to sterilize global central bank liquidity swap funding arrangements that were introduced before the holidays and which therefore motivated a modest expansion of the Fed's balance sheet in late 2011 (chart 4).

The other is the 'operation twist' program that is scheduled to expire mid-year. It cannot — to the relief of insurers and pension plans — be expanded because the Fed went practically to the maximum in punting the supply of short-dated securities further along the curve.

Absent the introduction of a new stimulus program, the Fed's balance sheet (chart 5) would either be flat-lined if reinvestment continues, or shrunk if reinvestment does not continue. We think either outcome is not desirable given renewed challenges to the Fed's dual mandate.

Chart 4

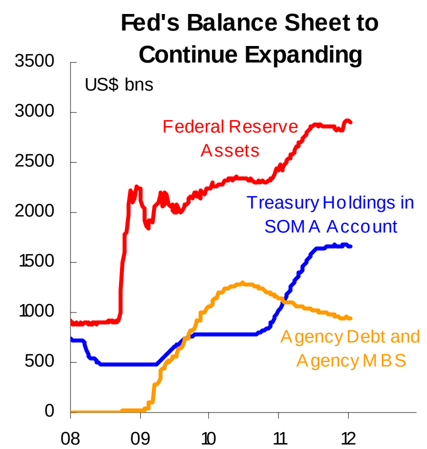


Source: Bloomberg, Scotia Economics.

3. Published Rate Projections Will Offer No Stimulus Effect

Further to #2 above, the publication of projections for the Fed funds target rate by Fed Governors and Federal Reserve District Bank Presidents will not offer stimulus to the US economy — even though some think it will. We explored this in some depth in our piece "The Federal Reserve's Step Toward Published Rate Forecasts Carries Concerns," pp.5-6, *Global Views*, (January 6, 2012). For one thing, the market is already convinced rates are going nowhere for a long time. Further, the poor international experience of other central banks that publish their rate forecasts combined with the domestic limits to the powers of monetary policy constrain the effectiveness of the Fed's move to publish rate forecasts.

Chart 5



Source: Bloomberg, Federal Reserve, Scotia Economics.

4. Balance Of Opinion At The Fed

Also consider that the balance of Fed policy makers who have spoken over recent weeks appear to be open to further stimulus. This is particularly true when power-weighted to the Bernanke core and after considering that last year's relative hawks — Fisher, Plosser and Kocherlakota — don't get a vote on the FOMC this year and are only alternates next year. This is a point we have been stressing over the past year.

5. The Fed Believes That It Has The Necessary Tools To Reverse Mistakes

The core set of policymakers is also driven by the conviction that if they err too far on the stimulus side, then they have the tools to rapidly unwind stimulus when the time comes. Technically that's correct, as the Fed can employ a range of ways by which to withdraw liquidity from markets such as halting purchases and reinvestments, reverse repo transactions, hiking interest on excess reserves and the fed funds target rate, term deposit sales, perhaps reduced duration of the SOMA portfolio, and ultimately asset sales over the longer run. In practice, however, the Fed has had a checkered history at timing cycles. Regardless, if Fed officials are convinced they have the tools that are needed to alter policy when needed, then adding stimulus may be tantamount to cheap insurance on achieving the Fed's dual mandate from their perspective.