

In Focus

July 14, 2011

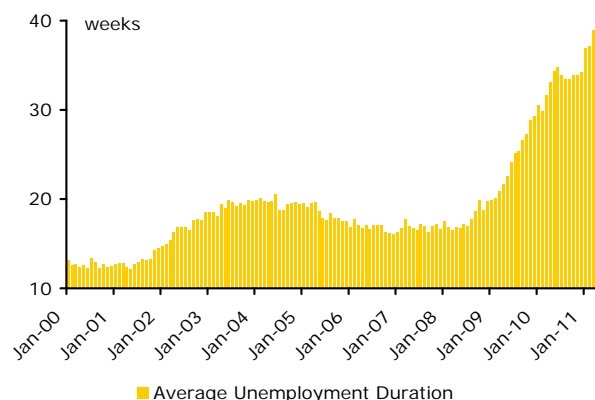
Emanuella Enenajor (416) 956-6527

The Fed and Prospects for Easing

The recent slowdown in US job creation and production suggest that despite the end of the Fed’s second round of asset purchases (QE2), further monetary easing cannot be entirely ruled out. That notion had markets initially celebrating, when Bernanke testified before the House of Representatives on Wednesday that the Fed would be able to respond with further accommodation in the event of a protracted weakness in US activity. However, the bar for another dose of asset purchases is relatively high, and despite deterioration in several economic indicators, the Fed chief emphasized today that “at this point” no further stimulus to the US economy could be expected, dashing hopes that a start to QE3 was around the corner.

1. Bernanke recently described the US labour market as being in a crisis, with slow job growth and elevated long-term unemployment (Chart 1). Consumption, accounting for 70% of GDP, will need to get a boost from increased hiring, as stagnant wages are conspiring to keep consumption weak. The tepid pace of US labour market recovery and added drag from a double-dipping housing market suggest the Fed will be delaying its exit strategy, in line with our view of no move in the Fed Funds target rate until at least 2013.

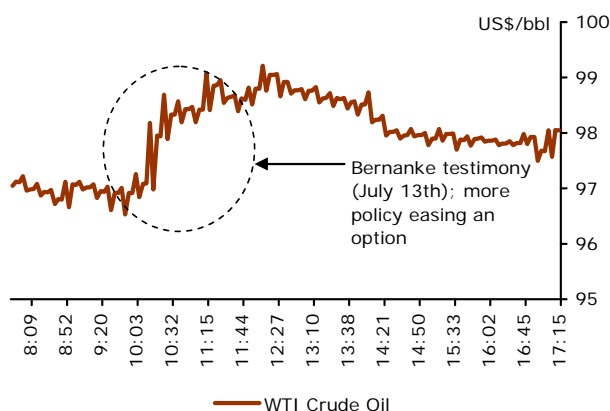
Chart 1
US Labour Market in Crisis



Source: Haver Analytics, CIBC

2. But the Fed is still concerned about inflation, which reached 3.6% in May, driven by elevated food and energy price gains. While Bernanke emphasized that the persistent rebound in energy prices has been driven primarily by emerging market demand, the \$2 spike in the price of crude oil following Bernanke’s initial suggestions of further easing (Chart 2) suggests that some market participants are viewing QE or the prospects for further easing as a green light to long commodities (as well as other risk assets). In light of Bernanke’s

Chart 2
Bernanke’s Woes: Energy Prices Rally on QE3 Outlook



Source: Bloomberg, CIBC

cautious statements on inflation to the Senate today, energy prices have reversed sharply. We think that a rally in crude-oil in anticipation of further monetary accommodation may prove self-defeating if it stokes inflationary expectations, discouraging further Fed action.

3. QE3 isn't the only way to keep policy accommodative: Bernanke outlined several options for how policy can be eased on Wednesday, with the first on the list being more explicit guidance on how long the Fed Funds rate would remain at its record low, similar to the Bank of Canada's "conditional commitment". That statement could provide a more explicit time-frame (i.e. 1 year or 2 years) on how long the Fed Funds rate target would remain in its current 0%-0.25% band, impacting the longer end of the yield curve. Research from the BoC on the Canadian experience in 2009-10 (see Bank of Canada: He, 2010) finds evidence of an impact on interest rates at 1-year terms resulting from the policy, with diminishing impacts at longer terms up to 10 years. Bernanke mentioned further increases in the balance sheet (QE) as the second option in the list, as well as lowering the interest rate paid on bank reserves as a potential alternative.

Implications and Actions: What would it take for another round of quantitative easing? We would probably have to see persistently weak job creation, leading to a stalled or rising unemployment rate combined with falling/stagnant energy prices and deteriorating inflationary expectations. For now, the Fed is likely to hold off on any further asset purchases, gauging whether its expectations of diminishing inflationary pressures and a pick-up in activity later this year prove correct. That wait-and-see approach suggests the US dollar trade-weighted index's policy induced slide could be clipped.

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