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Yellen's Task

The Federal Reserve used their policy announcement and the press conference following the announcement to alter their method of forward guidance. Previously, it had been the hard line 6.5 per cent unemployment target that would lead to a culmination of the third round of quantitative easing. Unfortunately, as the employment rate has fallen, and the overall labour market hasn't improved accordingly, there has been a realization that the employment rate is not a sufficient stand-alone measure for the labour market. Thus, the Fed has had to abandon this with a more qualitative approach. This creates a problem for those invested in these markets, for it has been Fed policy providing direction. With a more qualitative approach to guidance, the result will be more ambiguous policy statements from the Federal Reserve's Federal Open Market Committee (FOMC), and it will potentially lead to greater market volatility from the Fed as their guidance is open to misinterpretation.

One of the touted accomplishments of Janet Yellen's predecessor, Ben Bernanke, was that he played a role in making the Federal Reserve a more transparent institution. One action in particular was lengthening the FOMC statement that was released after each meeting giving investors and analysts a more detailed approach to how policy is conducted. This was a stark difference to much briefer statements from the Greenspan era that left much to speculation. The importance of this measure though was to eliminate potential shocks to the market. This is why the US Federal Reserve finds themselves between a rock and hard place, and potentially risk reverting back to their old ways with a less definitive approach.

A qualitative guidance approach allows the US Central Bank to act in a more discretionary manner as they do not run the risk of failing to meet predetermined objectives. The consequence will be less clarity from the Fed, which implies the possibility of bigger shocks or surprises for the markets. Former PIMCO CEO Mohammed El-Erian suggests equities sold off following the Fed statement due to an uncertainty premium, which can be thought of as the market pricing a discount for a much vaguer policy outlook. But the uncertainty looks beyond the termination of QE as there are questions surrounding the overall efficacy associated with the Fed's past course, and this is given QE could be terminated before the labour market is fully repaired.

It is difficult to refute that quantitative easing provided some form of benefit to the US economy; one in particular was supressing the longer end of the yield curve, which was of particular benefit to a troubled mortgage market. But with the Fed's dual mandate of stable inflation of 2 per cent as well as maintaining full employment, the abandonment of QE before achieving success in that regard is an admission of the Fed's shortcomings. And part of the problems is inherent in the American labour market. Long-term unemployed are structural issues, and unfortunately record low policy rates will not provide a solution to this problem. That's part of the reason the FOMC is forced to take this path of paring back QE.

Janet Yellen's key task will be to conventionalize the role of the US Fed. Her greatest risk is that as long as these markets continue to be driven by the guidance her institution provides as a more ambiguous approach will lead to much greater volatility. The only hope is that markets can move off the life support provided by central bank easing, and back towards being driven by fundamentals. In this case, central bankers can go back to operating in the shadows.

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