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The Imminent Taper

The markets reacted swiftly to the news of the Federal Reserve's FOMC's decision to not taper their asset purchases at their September meeting. The press conference following the policy announcement expanded on this to give the impression that the US Fed lacks confidence in the economic recovery to be able to pare back their extraordinary stimulus. While some question the Fed's credibility at this point and see Bernanke as a repeat offender for shocking financial markets, there could be other shifts going on at the Fed that have caused them to make this decision.

Earlier this year, it created a huge turn in financial markets when the Fed announced that they begin the withdrawal of their asset purchases later in the year. Immediately there was a huge selloff in all markets spanning from equities to bonds to commodities. The only asset for some stability was the US dollar. That helps explain the reaction Wednesday, when the markets took the complete opposite reaction to the Fed's decision to delay the much anticipated taper. And if Chairman Bernanke tried his best to make clear one single point, it was that the Fed's decision to taper was and always has been dependent on the economic data. Despite analysts and financial media over-interrupting his press conferences and meeting minutes, data indicating an improvement in the underlying US economy will allow the Fed to taper. Wednesday signalled that day is not yet here.

The job market had provided the best indication for market analysts for the direction of Fed policy. That is why, in an economic recovery, when those numbers are released each month so much weight goes to what they reveal. In this newsletter a few weeks back, discussing August's weak payroll report, I suggested this could give voting members uncertainty about the upcoming decision to taper, and create the potential for a few months delay, and that is exactly what we saw. Where the Fed used the unemployment rate as yardstick for the quantity of asset purchases to be made on a monthly basis, they realized that their yard stick was no longer the right measuring tool for the State's economic performance.

Bernanke cited problems with US job creation. Particularly as we enter a period of decreasing labour force participation, and a retiring boomer population that is not being replaced by a workforce with the same skill set. Thus an unemployment rate of 7 percent to allow for tapering asset purchases looks more like some arbitrary goal than one of actual substance. Better signs for the US employment front can be found in the 4 week moving average of weekly jobless claims as that number indicates almost 40 thousand fewer Americans file for unemployment benefits on a weekly basis as did 4 months ago; however, job creation is the foremost issue, and there are still 7 million Americans either under or unemployed since the peak before this crisis began.

Going forward, it's truly important that investors make themselves cognisant of two issues. These encompass the realm of possibilities in decisions that could come from the US Fed. Tapering can occur at any instance between now and the Fed's next meeting. It may not, but eventually the taper is inevitable. This could throw a bit of a curveball at the markets. Despite the Fed's asset purchases as of late being more impactful on sentiment, any announcement regarding change (or lack thereof) can act as a shock to the financial system.

The second is that investors may want to position themselves for an even more dovish Federal Reserve. While some argue Bernanke went back on his word or misled investors, I would suggest (with full credit to Pimco's Bill Gross) that the shift is beginning to see Fed Vice-Chair Janet Yellen's influence increase even more. Thus, this is why the market priced in her leadership overseeing the Fed Funds rate unchanged for a longer time horizon.

Although there are many uncertainties, one thing is clear; despite the Fed's increased transparency and despite their efforts to provide forward guidance—against all efforts to the contrary they still have the ability to send financial markets for a tailspin.