

## To taper or not to taper

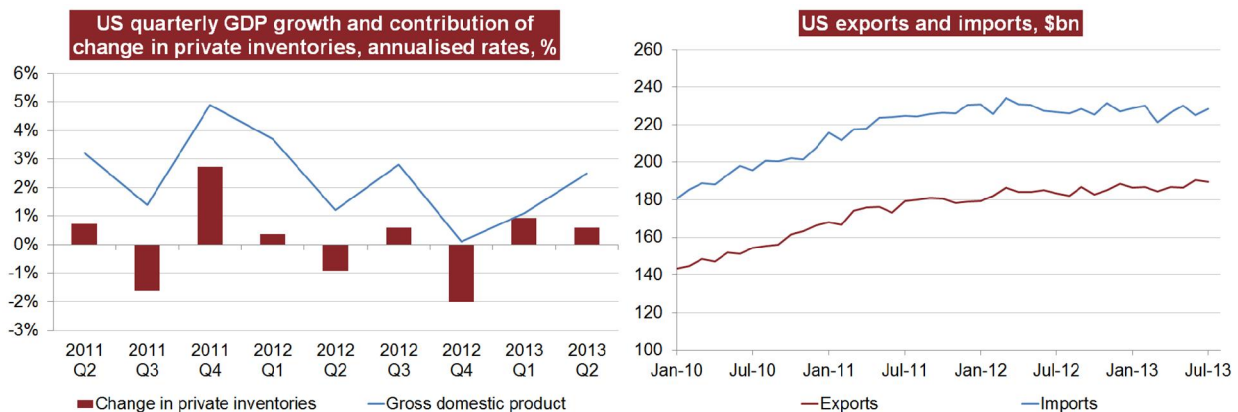
- **US recovery continues, but still disappoints**
- **Q3 is likely to see some weakness after a healthy Q2**
- **But the time for tapering QE – possibly with new conditions – has still come**

Next week the FOMC meets after an almost seven-week pause. Its post-meeting announcement will possibly be the most scrutinised for a very long time. Broadly speaking, there seem to be three options:

- Begin to taper QE this month.
- Set a date for the QE taper to begin, but not this month.
- Postpone the beginning of the taper, ie, no decision.

In addition, any decision could be hedged about with further conditions, eg, a new and lower threshold for unemployment or an inflation floor below which interest rates will not be raised.

While it is clear that the US recovery continues, its strength remains disappointing. True, Q2 growth was revised from a below-trend 1.7% to top-of-the-trend-range 2.5% (assuming a trend growth rate of 2-2.5%). However, much of the strength in the revision was in inventories and improved net exports. The former tends to be self-correcting. Inventories have now added to GDP in the last two quarters. To have more than two consecutive quarters with a positive contribution from inventories is not unheard of; but it is highly unusual unless it comes after a series of negative contributions. The pattern since 2011 Q2 is one of two quarters with positive contributions alternating with one or two negative, implying that inventories should subtract from growth in the current quarter. Moreover, recent trends show that a drag from private inventories is associated with a weakening of output growth. Meanwhile, July foreign trade data show that net exports also are likely to subtract from activity in the current quarter, with both exports and imports now moving sideways.

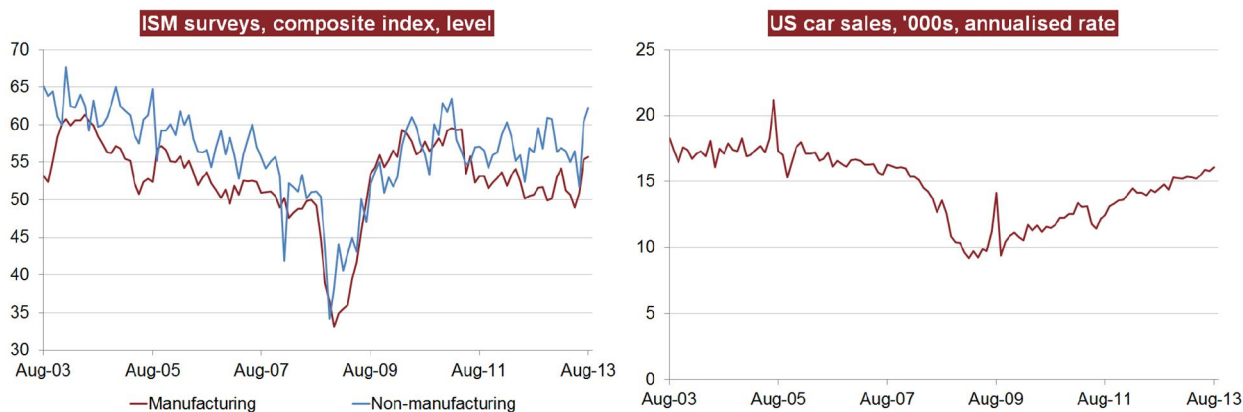


Stein Brothers (UK) Ltd.  
Telephone: +44 (0)7768 094 340  
Email: [gabriel.stein@steinbrothers.co.uk](mailto:gabriel.stein@steinbrothers.co.uk)

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There are further causes for concern about the US recovery. One is the weakness of consumer spending in July (up 0.1% but unchanged in real terms); another is the weakness in durable goods orders (July down 3.3% excluding defence and aircraft orders). But both these monthly series can be volatile. A more serious potential concern refers to the US banking system. As pointed out in a previous Comment (*The threat from – and to – banks' balance sheets*, 25<sup>th</sup> July, 2013), the shift in the composition of US banks' balance sheets, notably the fall in holdings of Treasuries and agency securities, is worrying. For the time being, it is more than outweighed by a rise in cash holdings. But that is due to the Fed's quantitative easing and if the Fed does begin to taper, this could constrict the future growth of the US banking system.

However, other data is considerably more bullish and at the very least implies that any weakness is likely to be short-lived. Broad money growth remains buoyant, rising at a twelve-month rate of more than 6% since last May. Significantly, the growth of deposits, which had slowed in the early summer, seems to have recovered. Business and consumer surveys are also turning up. The manufacturing and non-manufacturing ISM surveys both reached a two-year high in August, while the non-manufacturing survey business activity index reached an eight-year high. Car sales, a key indicator of consumer spending, reached their highest level since the Great Recession began.



The car sales confirm the steady but unspectacular rise in consumer sentiment as measured by the University of Michigan. While this index fell back in August (to 82.1 after 85.1 in July), July was the highest reading in six years and the trend is still up.

In between these two sets of data pointing in opposite directions, are some numbers that could be interpreted either way. Perhaps the most important are the housing and the labour markets (the latter mainly because the Fed has tied its policy to labour market outcomes). Both of these have recently seen some weakness. However, if anything, this shows the danger of relying on one month's data.

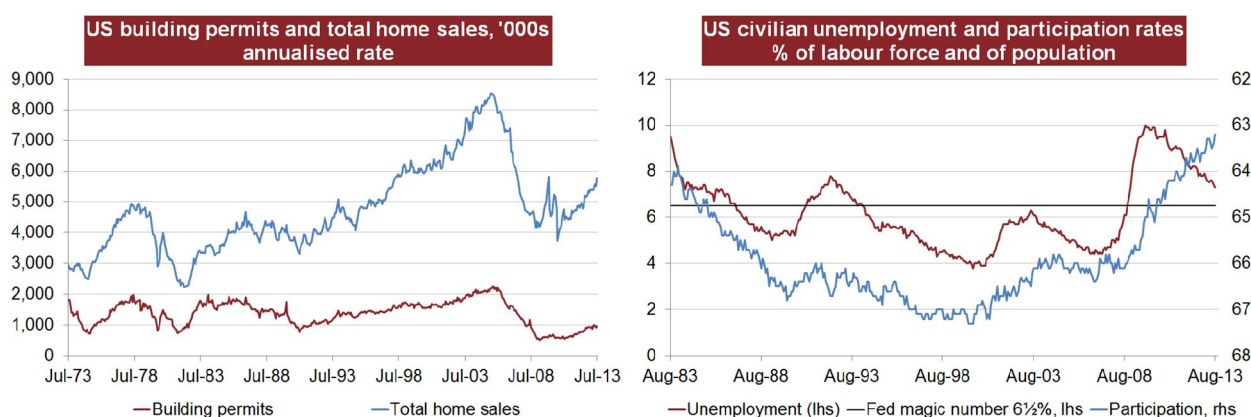
New home sales fell 13% in July, dropping below 400,000 units (annualised rate) for the first time this year. The twelve-month change dropped into single figures (6.8%) after 18 months in double digits, prompting concern that higher long-term interest rates, themselves a consequence of 'taper terror' were already aborting the housing activity, a key pillar of the US recovery. That is almost certainly a premature concern. The experience of previous interest rate cycles would rather point to households moving forward their purchases in order to lock in current – still low – interest rates. At the peak of the housing boom in

Stein Brothers (UK) Ltd.  
Telephone: +44 (0)7768 094 340  
Email: [gabriel.stein@steinbrothers.co.uk](mailto:gabriel.stein@steinbrothers.co.uk)

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2006, a 30-year fixed rate mortgage rate was between 4.5% and 5%; in August 2013, this was still only 3.8%, although that does represent a jump from 2.6% in July 2012. Moreover, total home sales in July were still 5.784 million units, the highest since late 2009; while building permits, monthly fluctuations aside, continue to advance, if erratically. Fears of a housing market implosion seem overdone.

The labour market is more difficult to call. First, because employment is a lagging, not a leading indicator. Second, because the most widely followed number, non-farm payrolls, is highly erratic with large error margins ( $\pm 100,000$ ) and is prone to substantial revisions. In addition, unemployment is affected by the participation rate. This was highlighted in August, when the rise in payrolls was less than expected (169,000 jobs added, instead of the 175,000 consensus) and July data was revised sharply down (from 162,000 to 104,000), yet the unemployment rate eased from 7.4% to 7.3%.



However, the fall in the participation rate is a long-term trend. While it is likely to be reversed, at least in the older cohorts who find that their savings won't allow them to retire, a rapid rise in participation sufficient to change the downward trend in unemployment seems unlikely in the near term. Hence, the labour market is likely to continue to improve in coming months and the Fed is still likely to find the unemployment rate at 6½% well before 2015. The Fed could expand the unemployment definition to encompass some participation rate, but that would leave it even further a hostage to developments beyond its control.

Ultimately, this is of course a judgement call for the Fed. But, on balance, the data seem to support an earlier start to QE taper as opposed to a later. Moreover, unless the Fed intends to continue with 'QE infinity', it will at some stage have to begin to decrease and then eventually to withdraw the monetary policy stimulus. Tying its decision to one or two months' data will only prolong market uncertainty – including in international markets. Better to take the plunge now and at least announce a date when the QE taper begins. Since by the time the FOMC finishes its meeting we will already be in the second half of September, the most likely announcement will also be just that; announcing that the quantitative easing will begin to be phased out, most likely beginning in October and over a period of 6-8 months. Possibly, this will be accompanied by a lower unemployment threshold and the introduction of an inflation floor.

Gabriel Stein 2013-09-12  
[gabriel.stein@steinbrothers.co.uk](mailto:gabriel.stein@steinbrothers.co.uk)

Stein Brothers (UK) Ltd.  
Telephone: +44 (0)7768 094 340  
Email: [gabriel.stein@steinbrothers.co.uk](mailto:gabriel.stein@steinbrothers.co.uk)

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