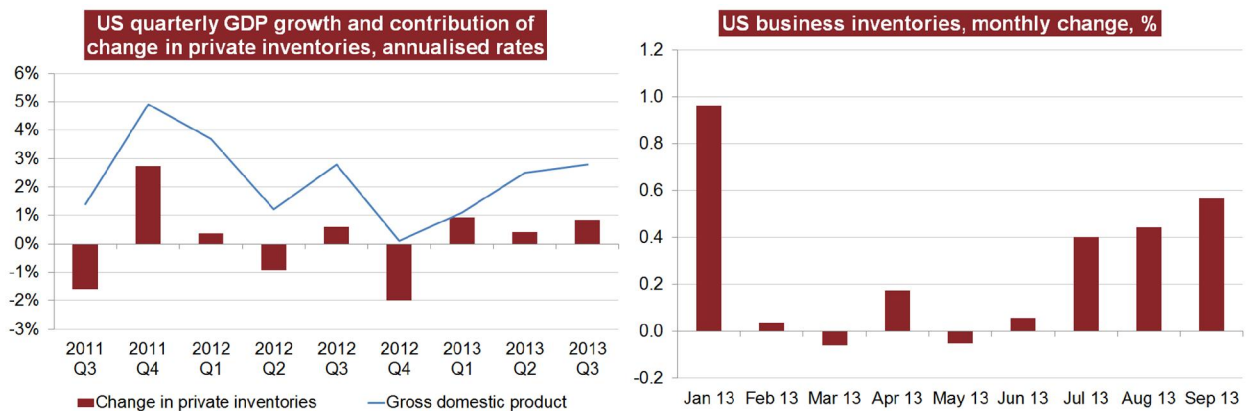


US – good news is bad news is good news

- **Markets (rightly) treated good news as bad news, meaning good news**
- **But the underlying economy is strong**
- **Accelerating output growth and continued ultra-loose monetary policy is good for equities**

Recent US data have generally surprised somewhat on the upside. Quarterly annualised GDP grew by 2.8% in Q3, above trend (generally estimated at 2-2½%); and non-farm payrolls rose by 204,000 in October. The latter will almost certainly be revised not only once but twice. Payroll data revisions for August and September were sharply up, indicating that the Fed, like the Bank of England, may have to confront reaching its (current) unemployment rate threshold well before it expected to do so. However, stock markets treated the good news as bad news – which is good news to them, since it means continued ultra-loose monetary policy and little prospect of the Fed beginning its QE taper just yet, let alone move towards higher interest rates.

For the moment, this is a correct interpretation. The strong GDP number (good news) was primarily due to a continued rise in inventories (bad news), which contributed 0.8 percentage points to overall growth of 2.8%. Moreover, the strong rise in business inventories in September (up 0.6% after 0.4% in August) means that the headline real GDP number is likely to be revised up. The September inventories rise implies that Q3 growth could be revised up by as much as 0.6 percentage points.

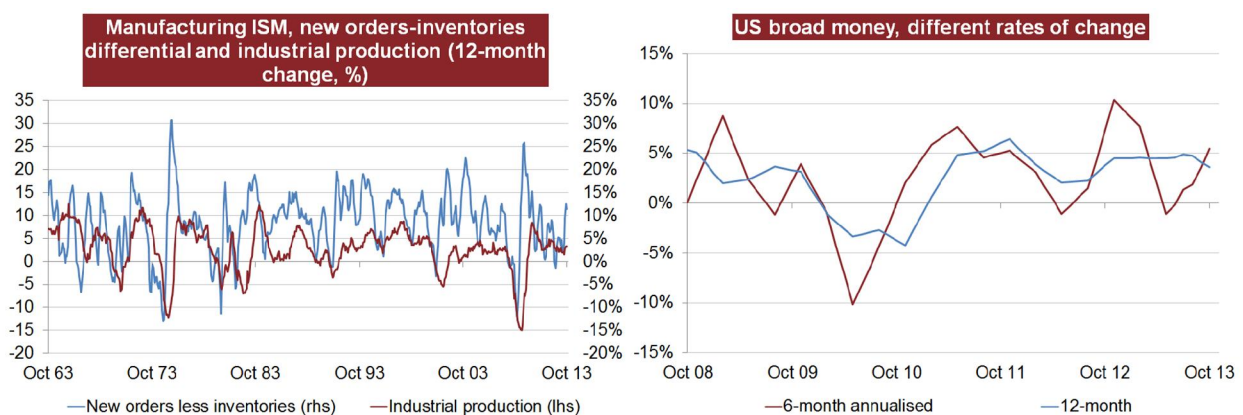


The Q3 inventory boost to real GDP growth marked the third consecutive quarter of positive inventory contributions. Although three (or more) consecutive quarters of a positive contribution are not unheard of, such a spell tends to be associated with weaker GDP growth in the following quarters. While the latest monthly increase in stocks is partly holiday related, it seems likely that some of the recent accumulation of inventories (up \$86bn in Q3 after a \$57bn rise in Q2) was involuntary. Therefore the inventory build-up will probably reverse in Q4 – possibly dramatically – subtracting from GDP. Add to this fiscal uncertainty and a slowdown in housing activity, and the near-term outlook is less than stellar.

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

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.

As for the labour market data, the numbers may have been somewhat distorted due to October's government shutdown. But, more importantly, as the 6.5% unemployment rate threshold approaches, it is looking increasingly likely that the Fed under its new Chairman Janet Yellen will lower the rate at which it may consider a change in policy. This has already been flagged by two regional Federal Reserve District Presidents (Messrs. Kocherlakota and Evans) and received strong support from current Chairman Bernanke, who stated on 19 November "The target for the federal funds rate is likely to remain near zero for a considerable time after the asset purchases end ... perhaps well after the unemployment threshold is crossed." The latest FOMC minutes show some opposition to a changed threshold, but a lower threshold fits with views already expressed by Yellen, to the effect that she does not intend to raise rates merely because unemployment has reached 6.5%.



While Q4 GDP growth may therefore prove weak, the US economy retains a robust underlying dynamic and growth should reach trend no later than mid-2014 and then to accelerate further in H2 2014. At the moment, some of that strength is admittedly only visible in survey data. But survey data should lead developments 'on the ground' and there are already some 'hard' data showing an improvement, such the October retail sales numbers (which were stronger than expected) and manufacturing output.

The latter should continue to improve. The manufacturing ISM survey may have disappointed, but the differential between new orders and inventories, which historically has been a leading indicator of industrial production, is rising strongly. Meanwhile, broad money growth has eased on a twelve-month basis – the growth rate fell to 3.6% in the year to October, the first number below 4% in a year – but this was due to weakness earlier in the year. On a six-month annualised basis, a better guide to recent trends, money growth is firming again.

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

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.



When will the Fed implement a shift in its monetary policy? Much interest has recently been directed towards the idea of 'optimal control', not least since Yellen referred to it in a speech in June last year.¹ Basically, a monetary policy based on optimal control looks at the desired target or targets for monetary policy and models a path to reach it (them). In practice, it is taken to mean that, as long as the central bank's medium-term inflation target is credible, it should keep monetary policy ultra-loose, even at the risk of exceeding the inflation target for some time. However, as John Williams, President of the Federal Reserve Bank of San Francisco and generally perceived to be a dove, has pointed out, this is all well and good if there is no uncertainty about the effects of monetary policy.² But since there usually is uncertainty, optimal policy is likely to be more muted than optimal control would have it.

Yellen's dovish views will have been strengthened by the latest inflation numbers; headline US consumer prices fell by 0.1% in October and only rose by 1% from a year earlier, the lowest number in four years. But inflation pressures have not subsided entirely – core inflation has been stable at 1.7% for the past seven months, as has the Dallas Fed's trimmed mean core PCE deflator at around 1.5%. Arguably, pursuing a policy that ultimately leads to an inflation overshoot, and encourages misallocation of resources along the way – as ultra-low interest rates eventually do – is far from an optimal policy.

Judging by the Minutes of the October meeting, the FOMC is still uncertain about when and how to move. While references to a possible QE taper "in coming months" have been interpreted as meaning December, they could equally well mean January or even March. Moreover, the Fed continues to grapple with how to get its message across. ("Participants broadly endorsed making the Committee's communications as simple, clear, and consistent as possible"). But, as pointed out in previous Comments, attempts to further clarify the future course of monetary policy, particularly if economic developments have not been quite as expected when the original guidance was introduced, risk complicating policy and creating further confusion.

Based on the outline above – trend growth by mid-2014, above-trend thereafter, the Fed's current 6.5% unemployment threshold should be reached by the middle of next year and the Fed should start normalising monetary policy in 2015. However, it now looks increasingly likely that the Fed will opt to keep interest rates at current levels for longer. That could prove to be a mistake.

Meanwhile, the combination of output growth accelerating and monetary policy remaining loose is good news for equities. It is not yet bad for fixed income; but eventually it will be.

Gabriel Stein 2013-11-21
gabriel.stein@steinbrothers.co.uk

¹ Perspectives on monetary policy, speech at the Boston Economic Club Dinner, Boston, Massachusetts, 6 June, 2012

² A Defense of Moderation in Monetary Policy, Federal Reserve Bank of San Francisco, Working paper 2013-15

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

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.