Petercam

Institutional
Asset Management

Outlook for the Fed

7 January 2014

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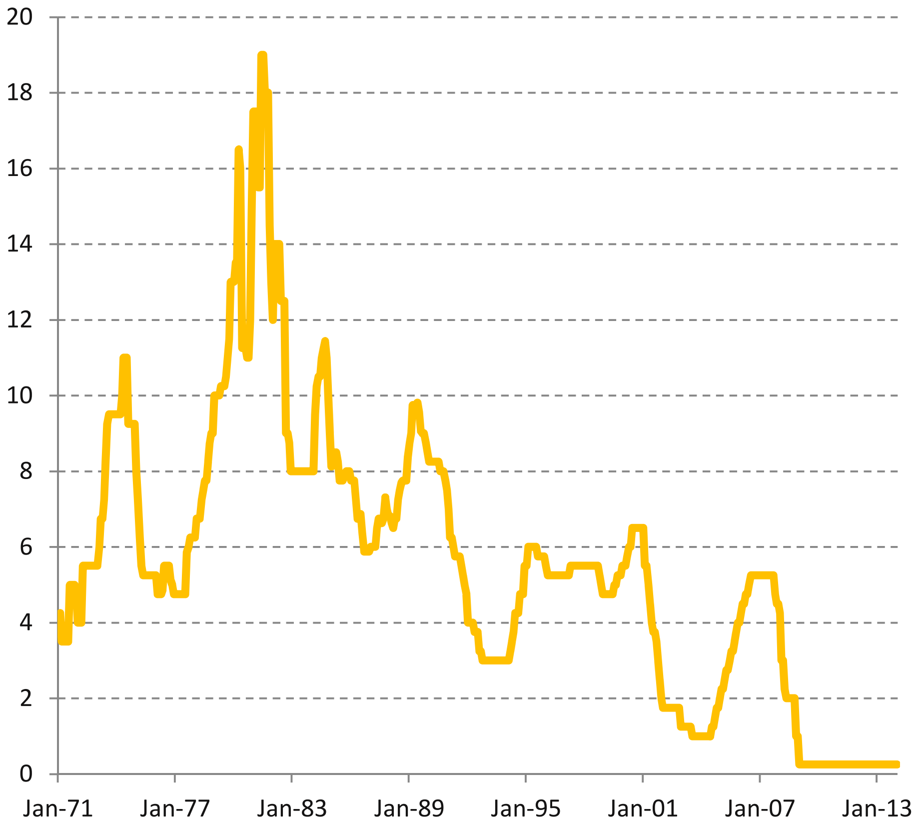
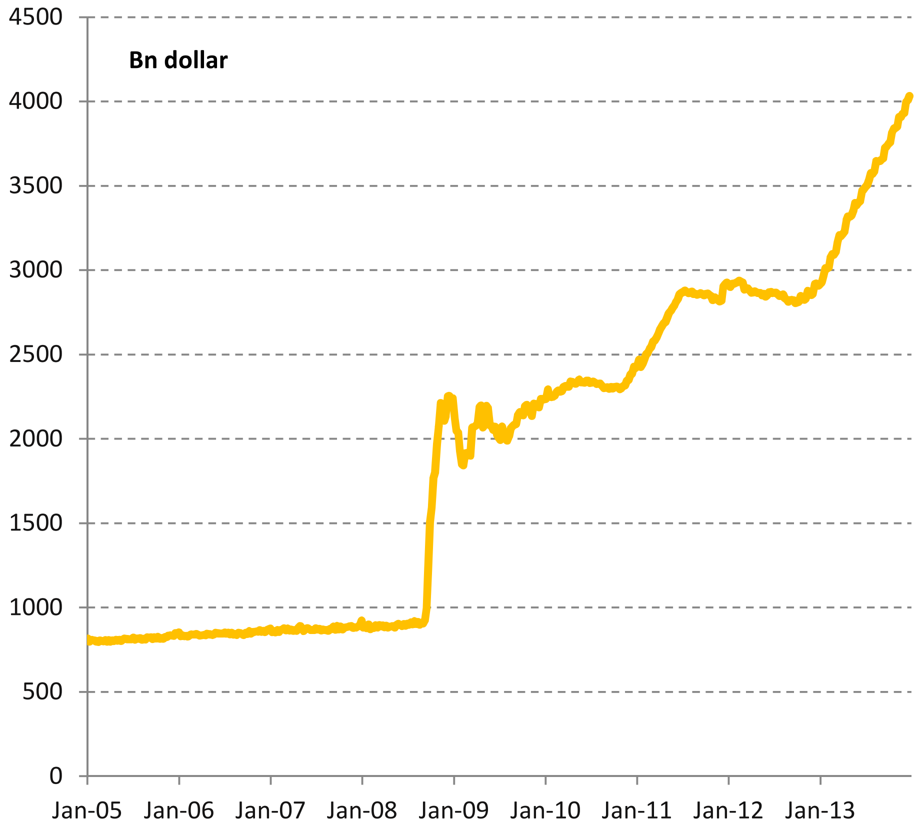
Extremely aggressive monetary policy

Fed policy rate



Fed balance sheet



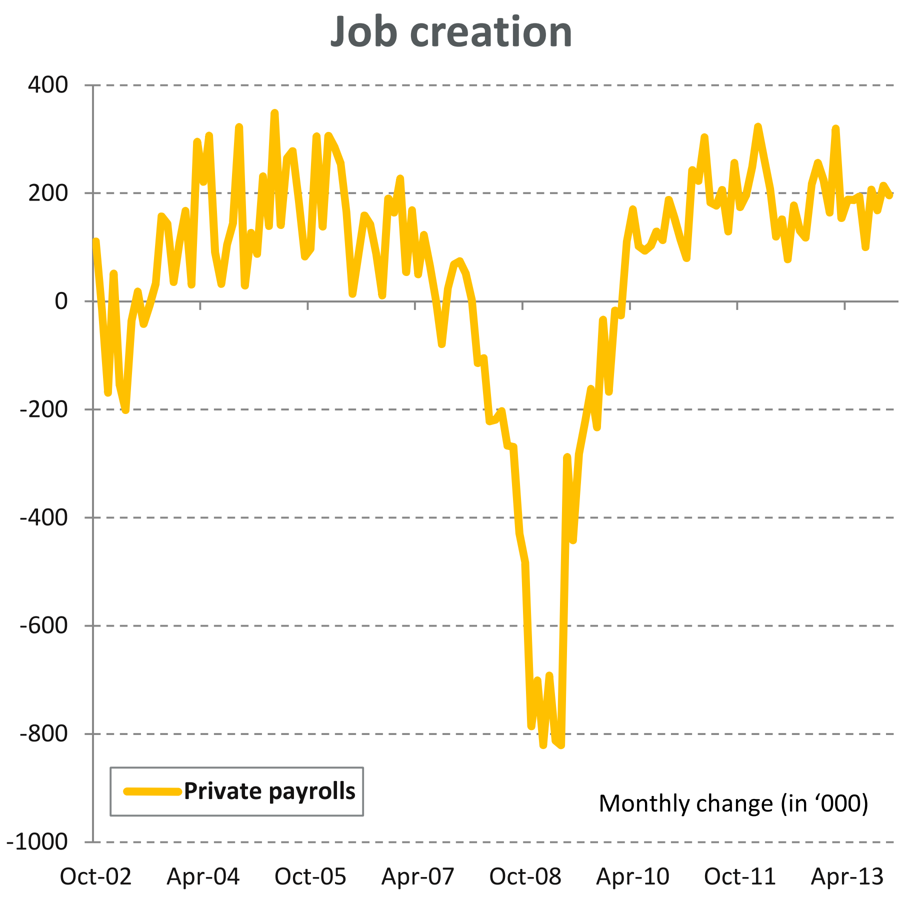
Key issues for the Fed

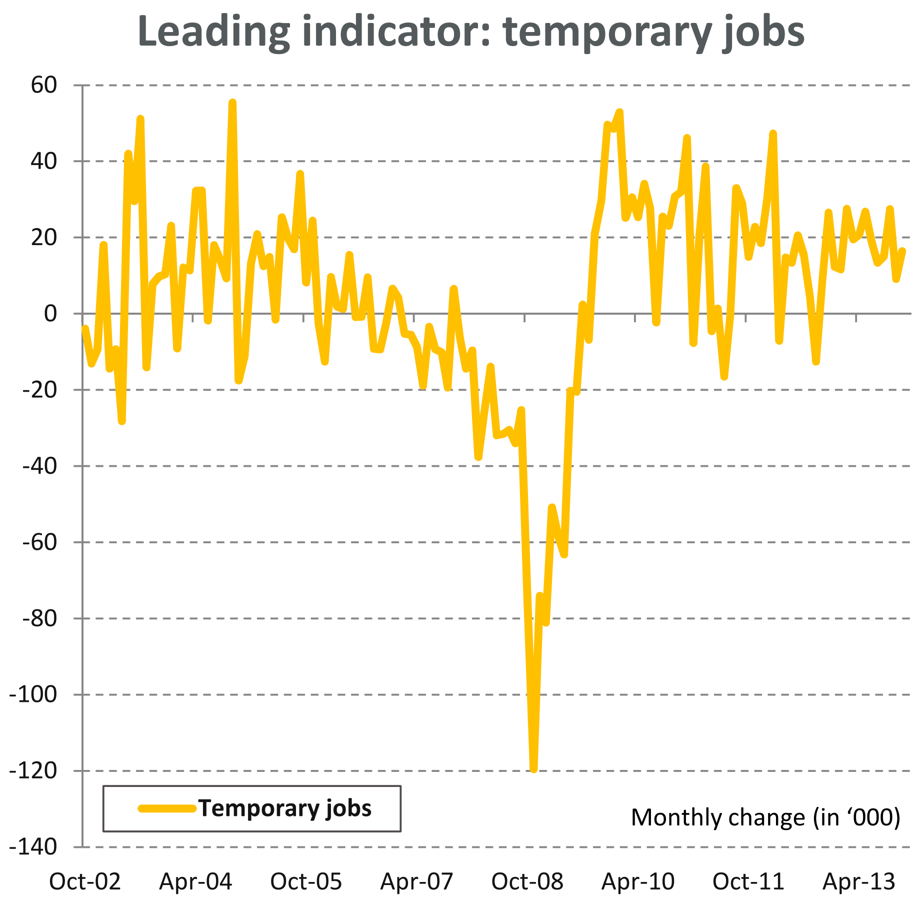
Current extremely loose monetary policy cannot continue indefinitely

Key elements to time the exit:

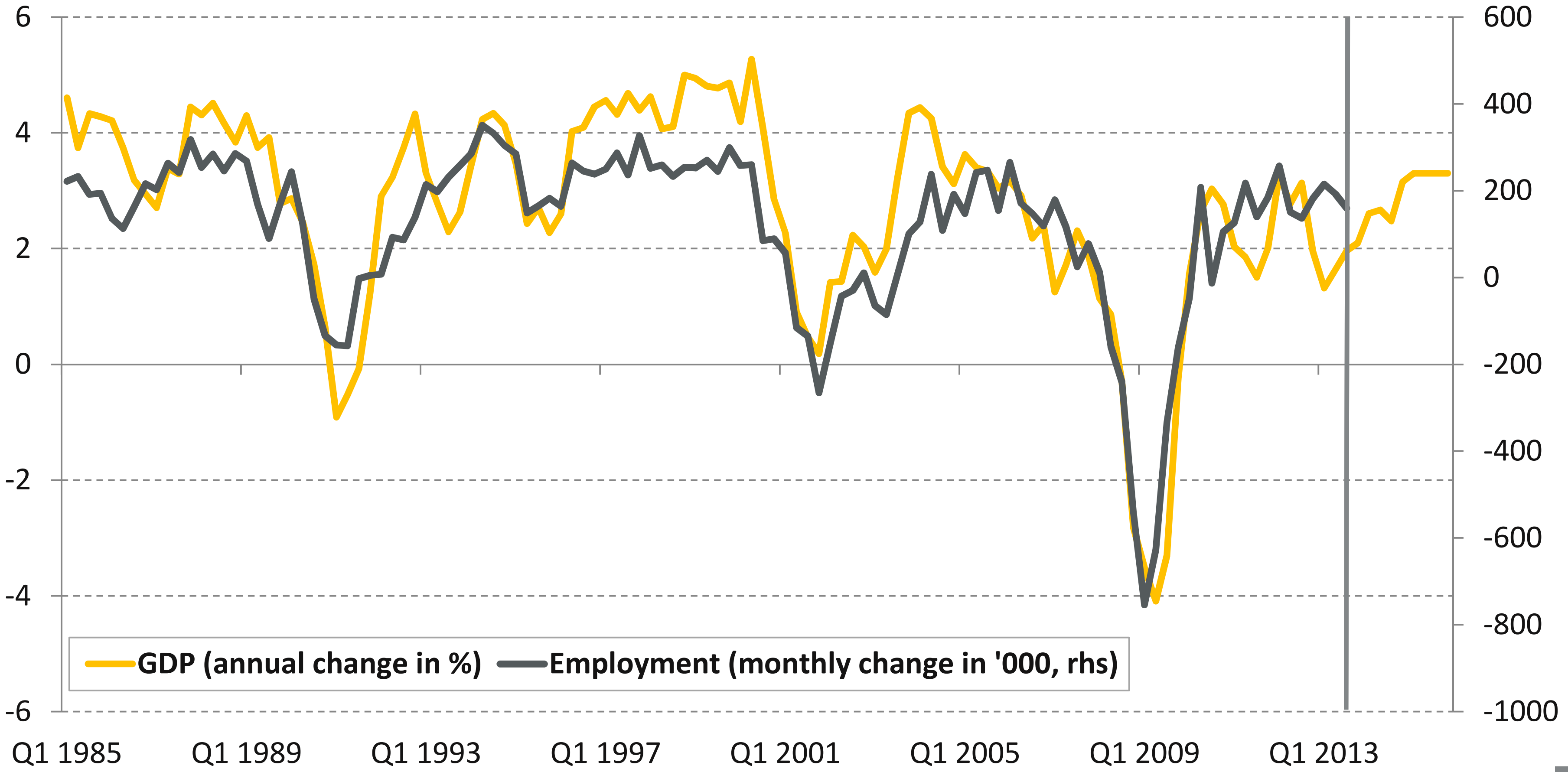
- **Labour market**
- **Inflation**
- **Bubbles**

Labour market continues recovery





Continued job creation…



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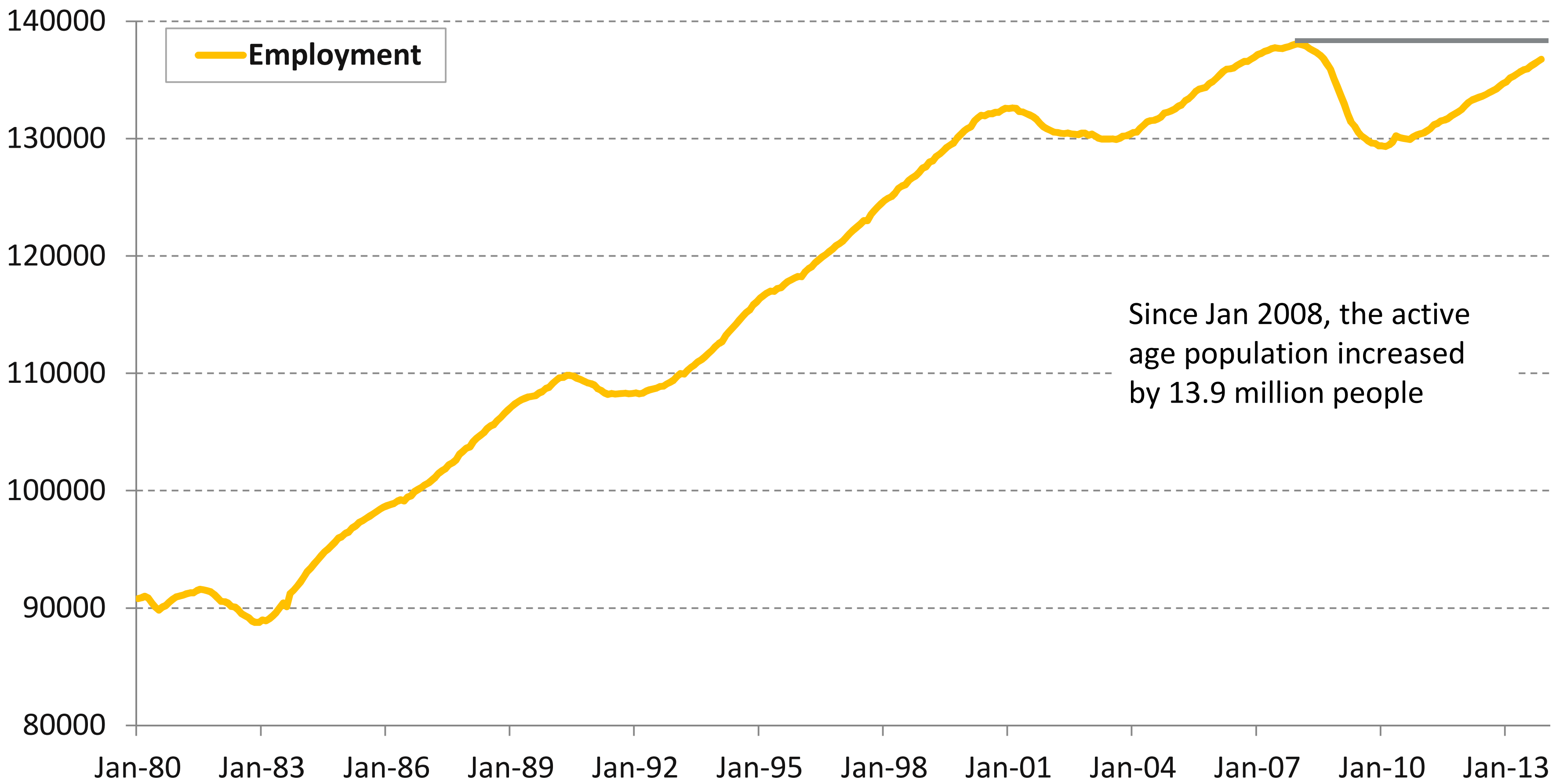
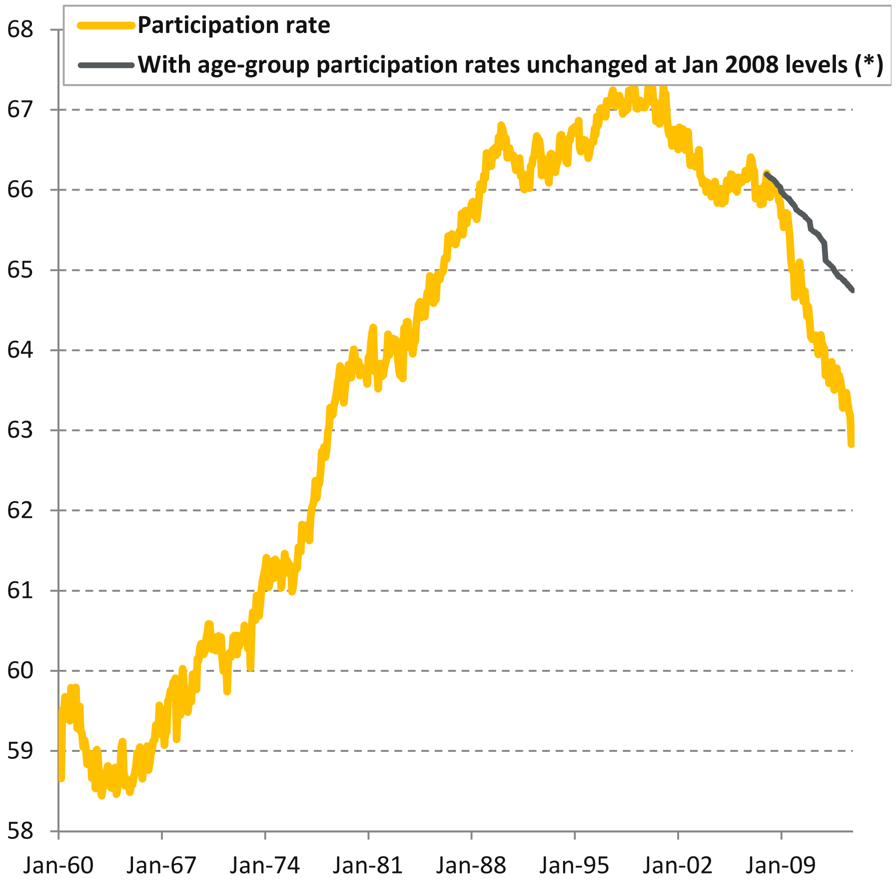
… but labour market still far from normality

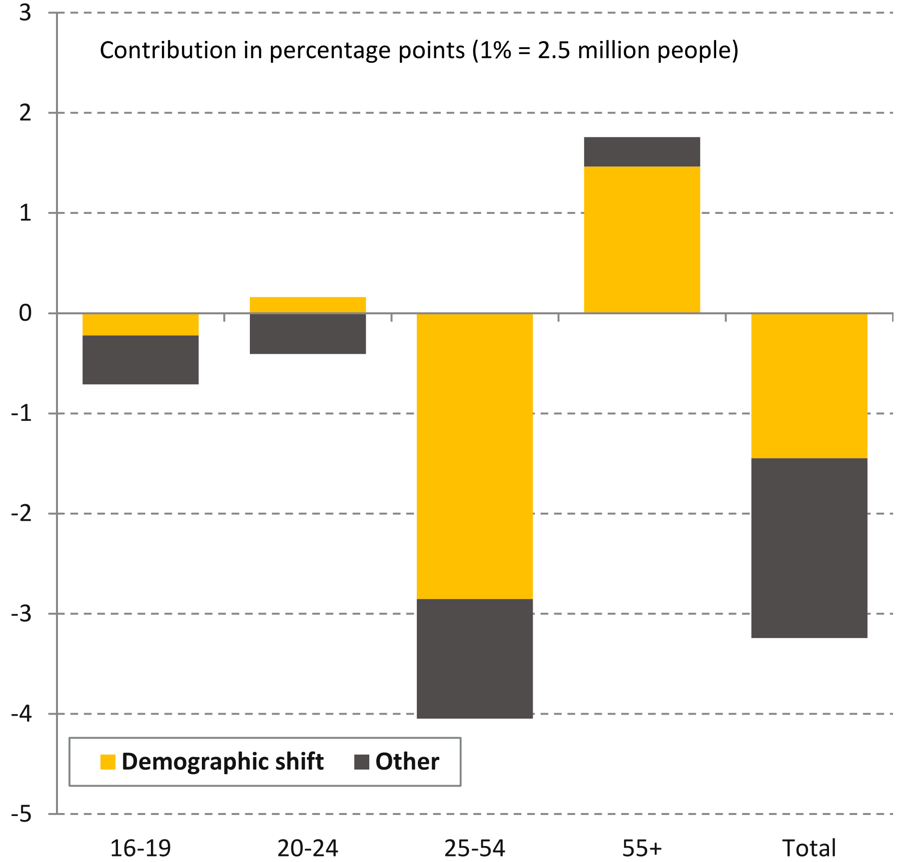


Spectacular decline in participation, partly due to demographics

Fall in participation, partly due to demographics

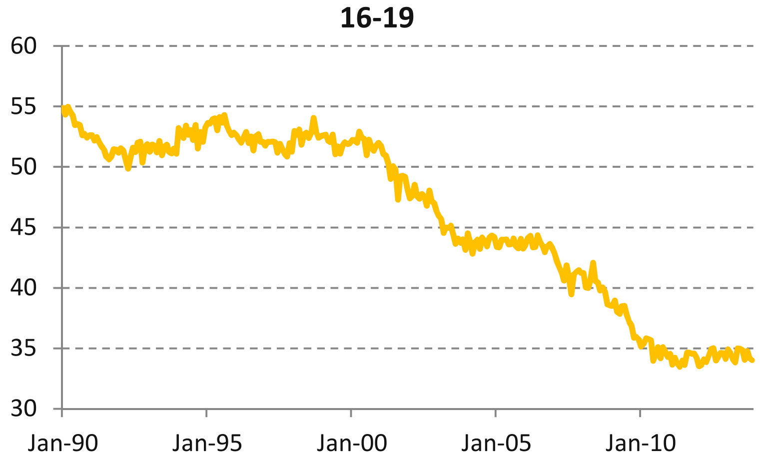


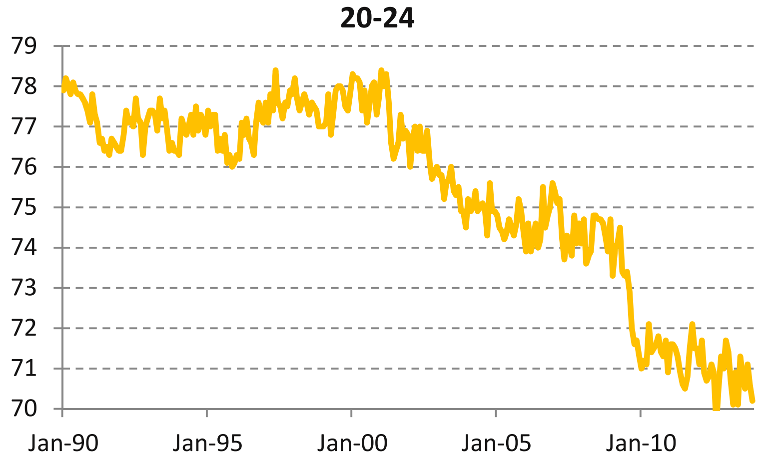
Change in overall participation rate

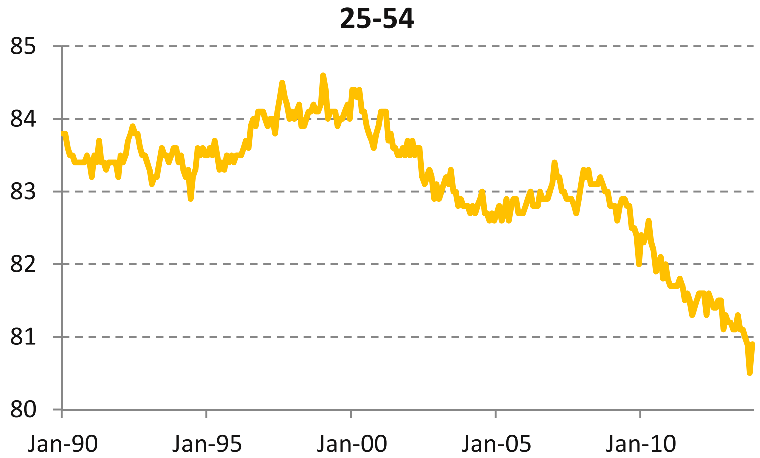


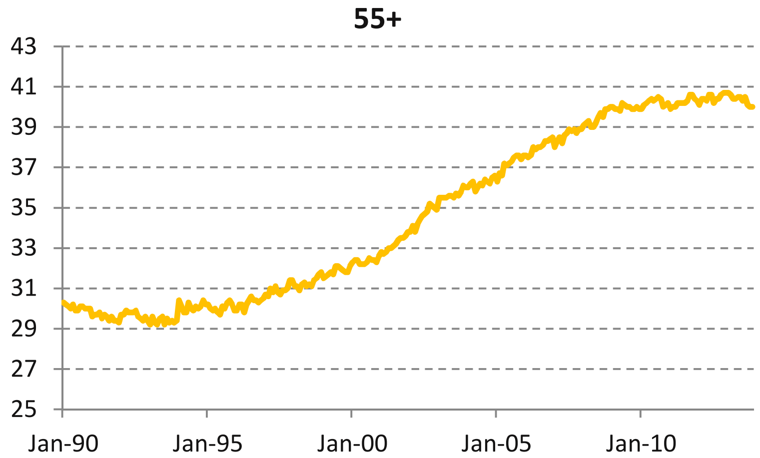
(*) Shows the evolution in overall participation rate due to increase in importance of older age groups with lower participation

Participation rates

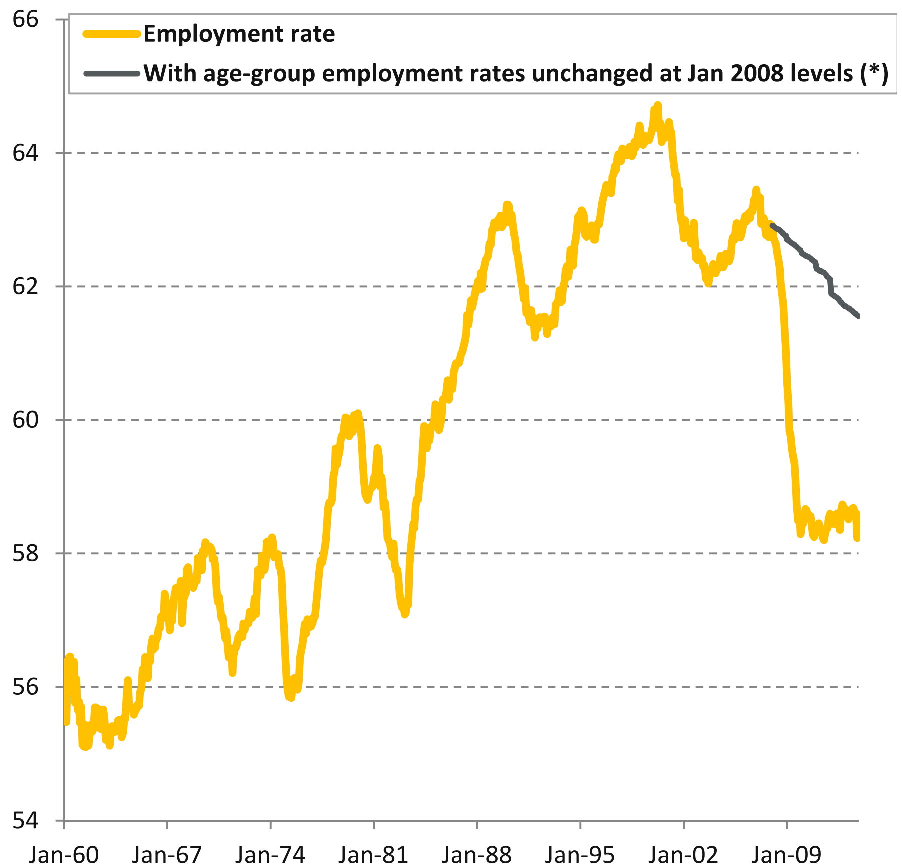


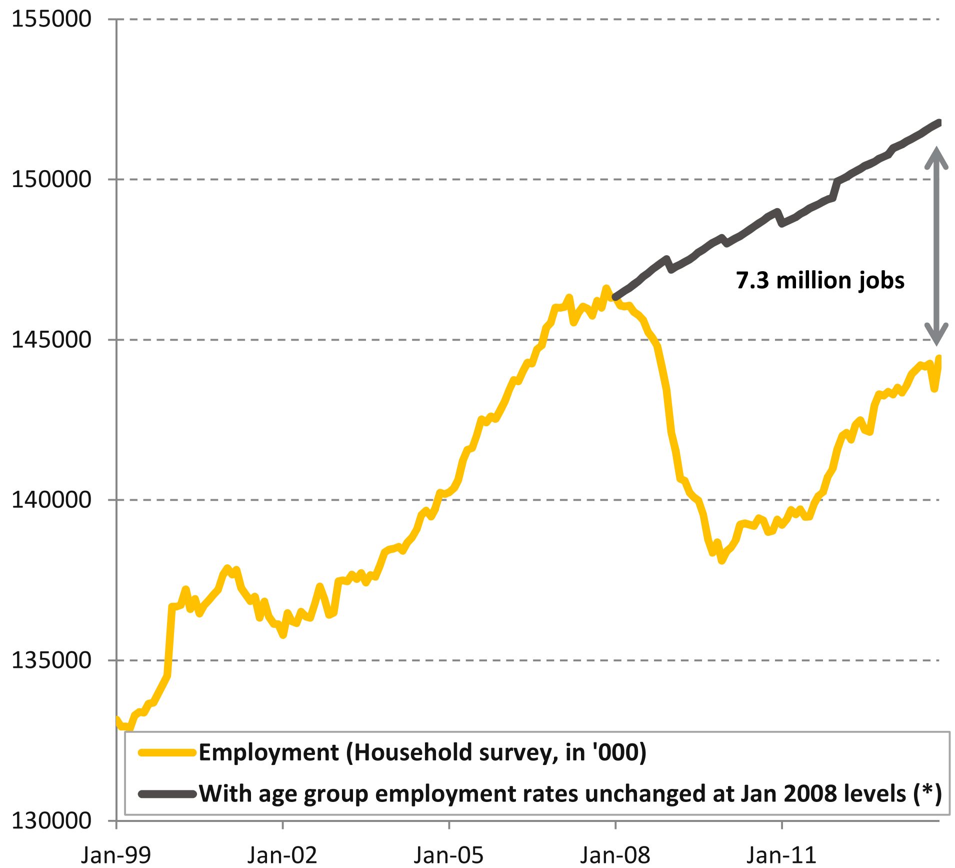






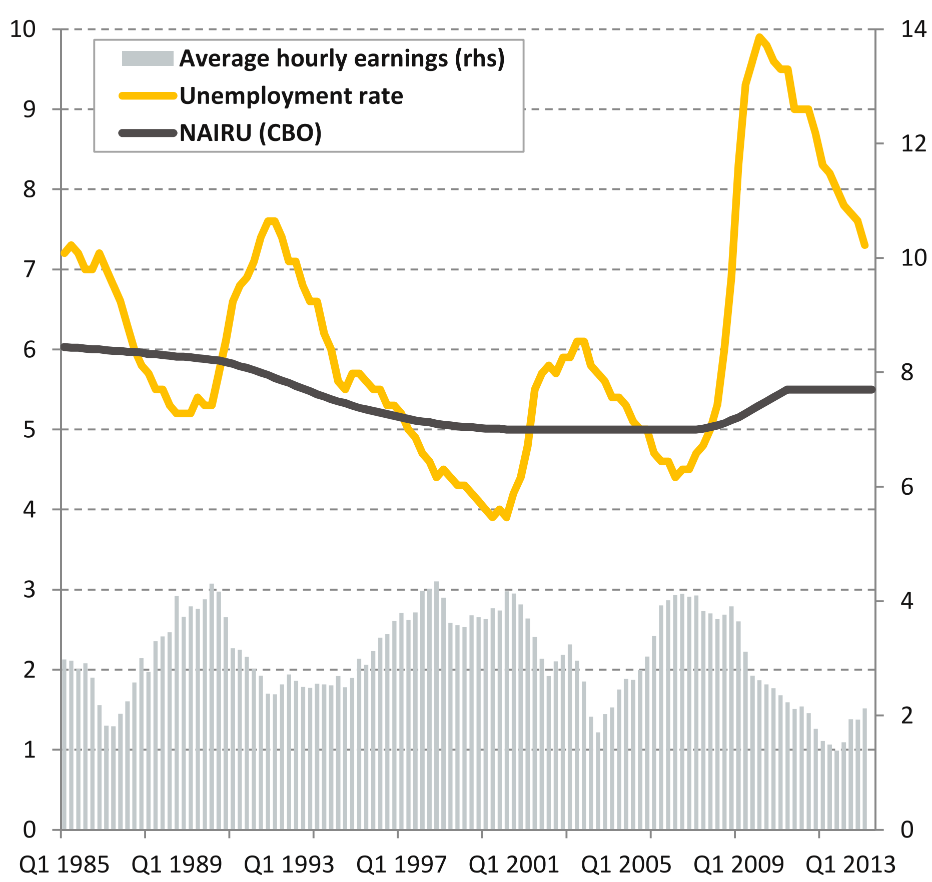
Ageing is having a structural effect on the labour market





(*) Shows the evolution in overall employment rate due to increase in importance of older age groups with lower employment rate

Wage pressure to remain limited



- The recent acceleration in wage growth raises questions about the amount of slack in the labour market
- Normally, the current amount of slack should exert downward pressure on wage growth
- One explanation could be that the NAIRU is significantly higher than current estimates
- Our take:
  - In previous cycle, the peak in unemployment coincided with the trough in wage growth (even if unemployment remained above the NAIRU)
  - There clearly is an element of downward rigidity in wages
  - Wage growth is rebounding from very low levels, but remains quite modest
- Wage pressure should remain limited

Fall in unemployment rate likely to slow as participation recovers

Participation rate	Monthly job creation	u < 6.5%	u < 5.5%
Stable at current level (63)	150	Sep-15	Beyond 2017
	200	Sep-14	Mar-16
	250	Jun-14	May-15
Gradual return to 63.5	150	Beyond 2017	Beyond 2017
	200	Oct-15	Beyond 2017
	250	Feb-15	Feb-16
Gradual return to 64	150	Beyond 2017	Beyond 2017
	200	Dec-16	Beyond 2017
	250	Oct-15	Oct-16

Average monthly job creation in 2012-13: 150k (Household survey)

Key issues for the Fed: labour market

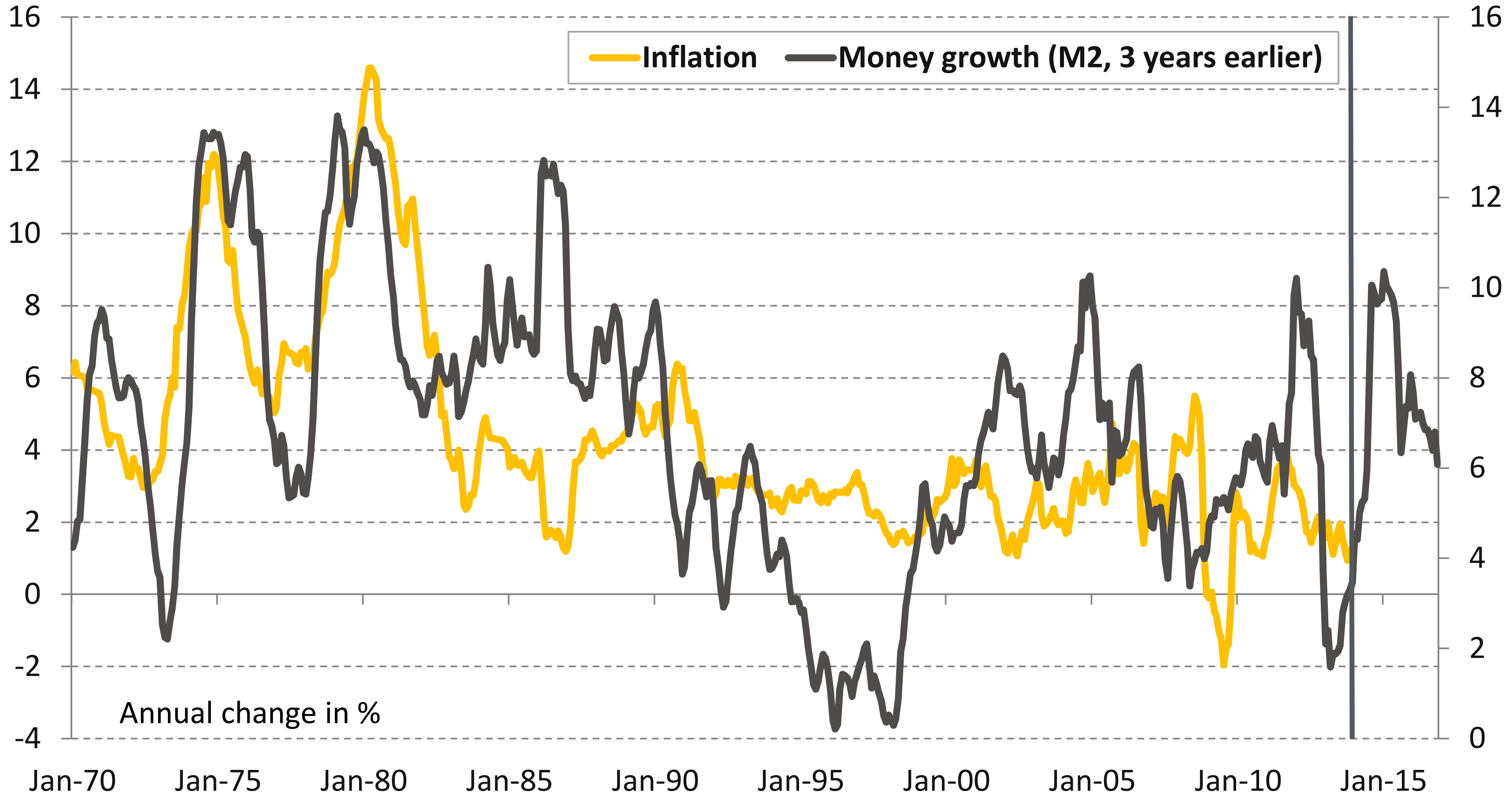
- Labour market recovery set to continue

- Slack in the labour market: participation is major question mark

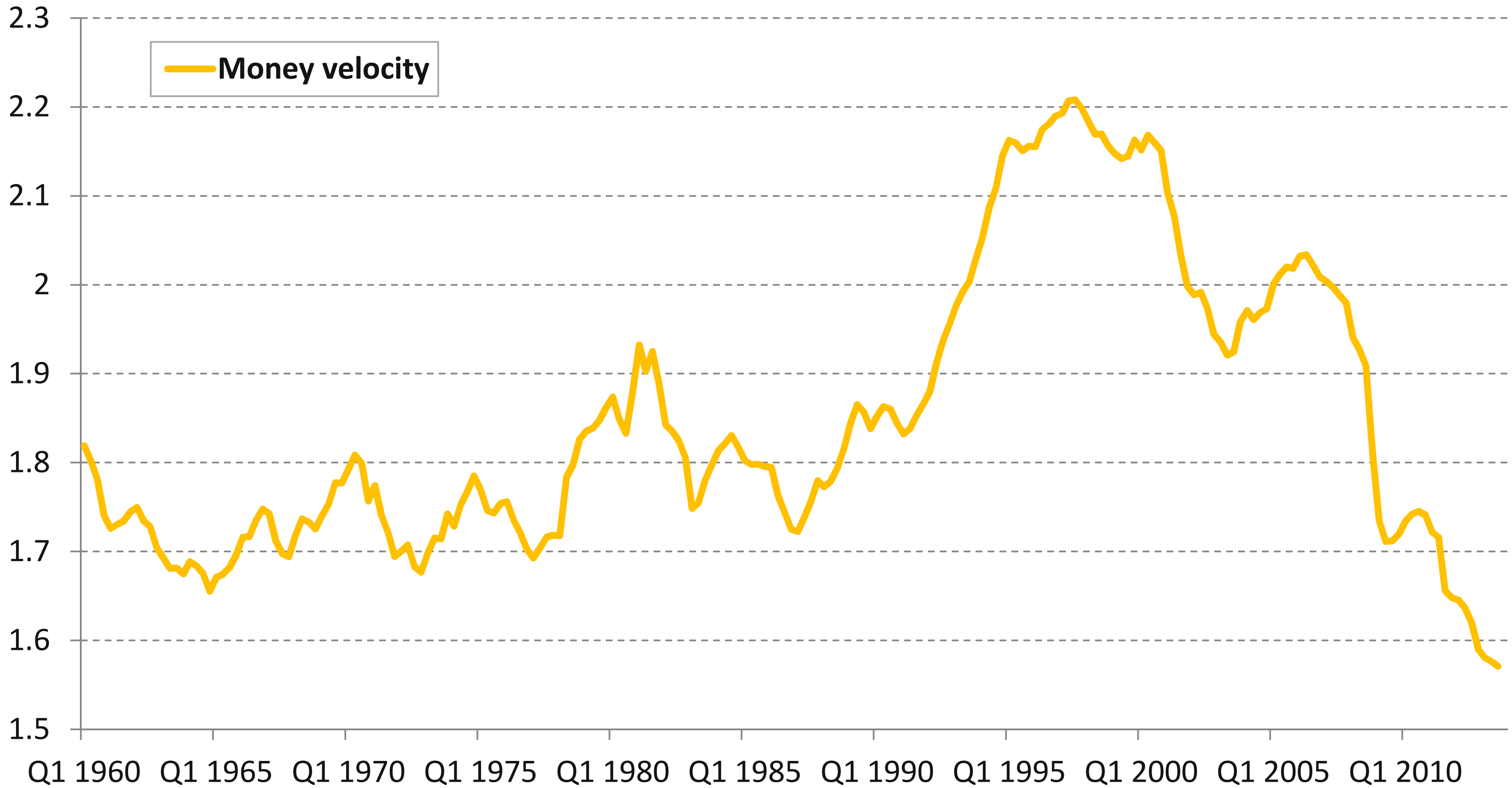
- An important part of the fall in participation seems cyclical (about 1 percentage point, or 2.5 million people), these people are bound to return to the labour market as the outlook improves

- Wage growth has picked up somewhat, but upward pressure on wages should remain limited for another year or two

In time, money printing creates inflation



New money isn't used: extremely low velocity



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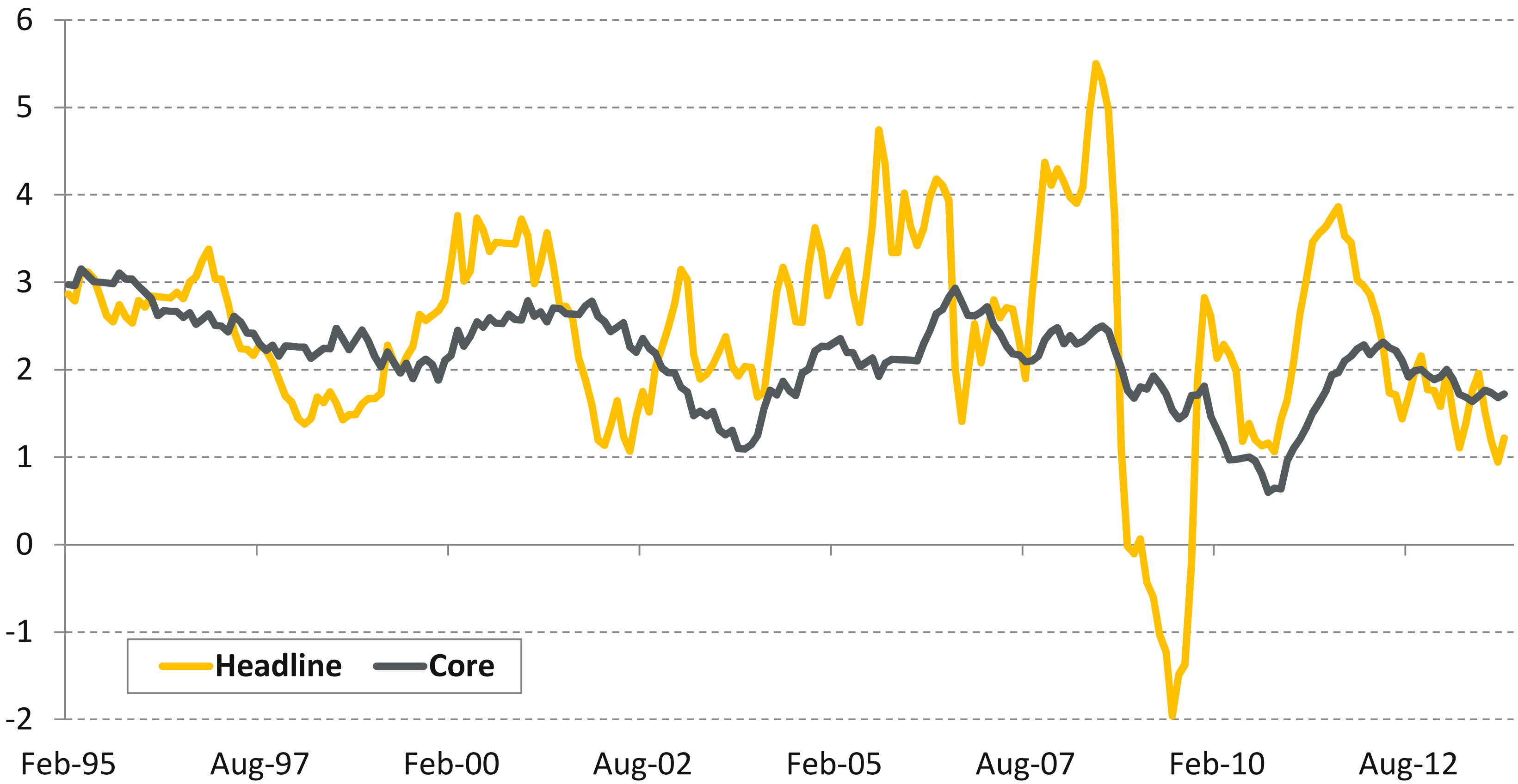
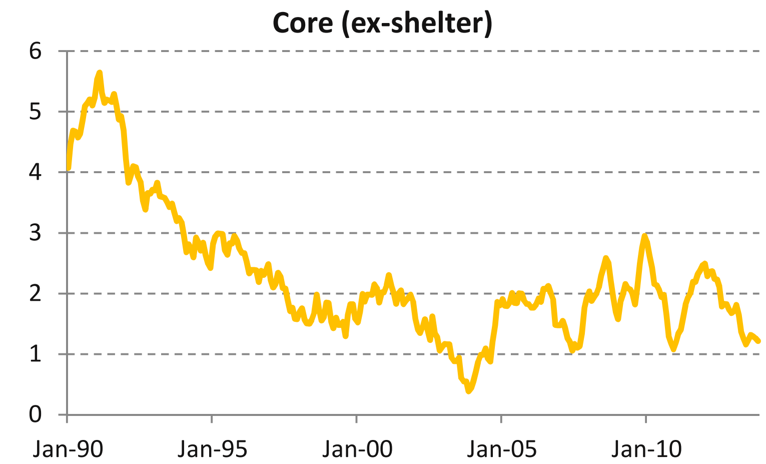
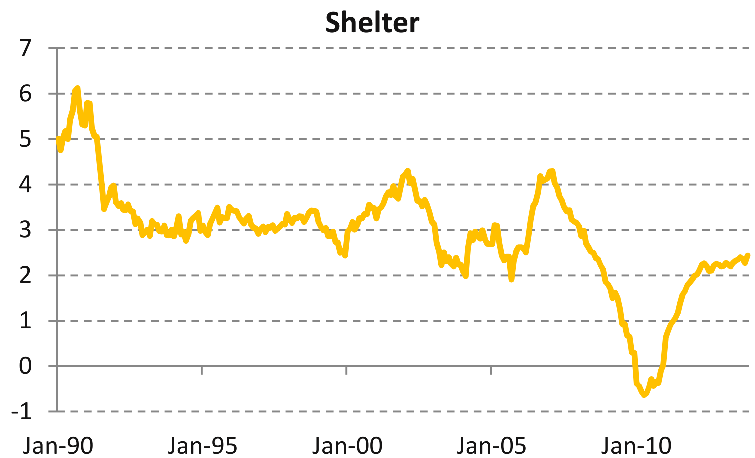
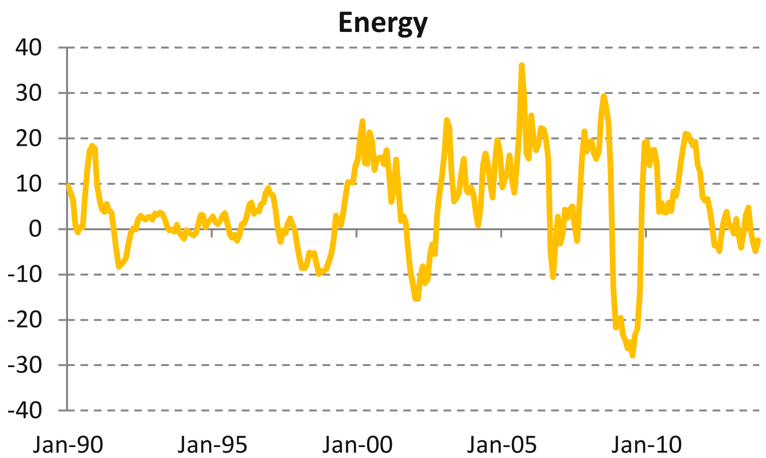
Inflation remains under control

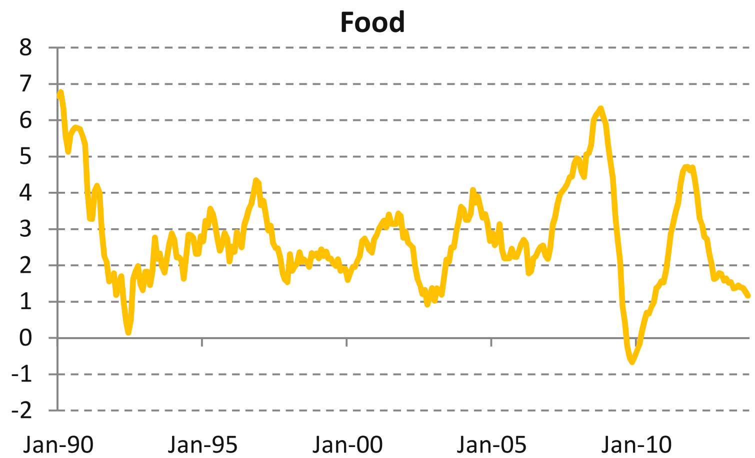


Inflation

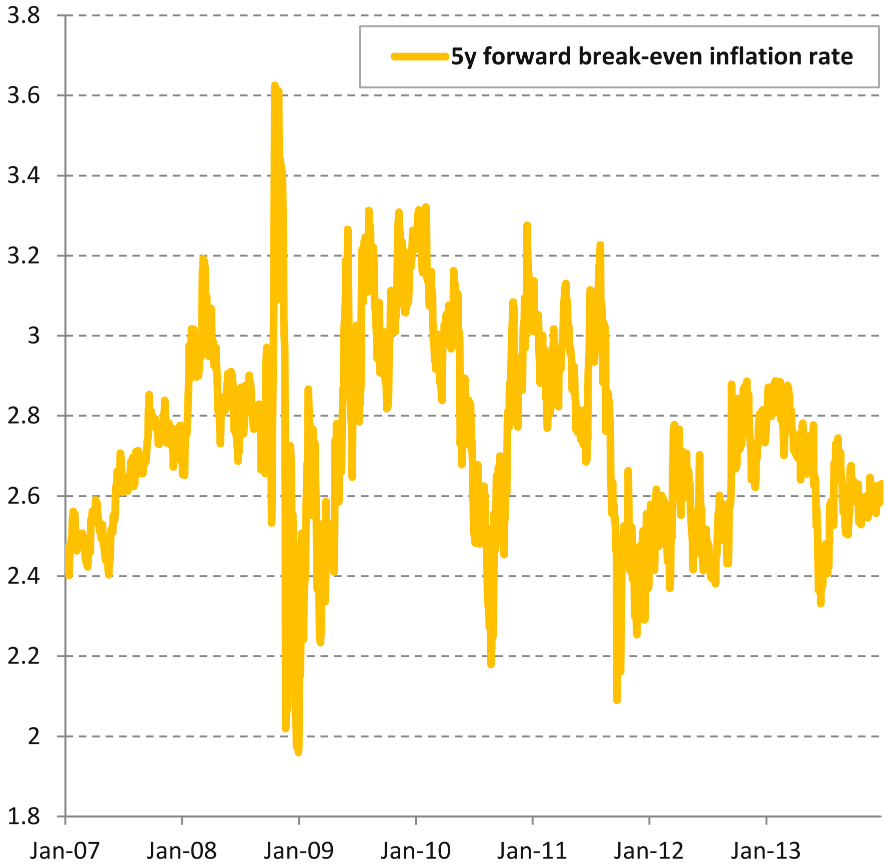

Core (ex-shelter)
6
5
4
3
2
1
0
Jan-90
Jan-95
Jan-00
Jan-05
Jan-10

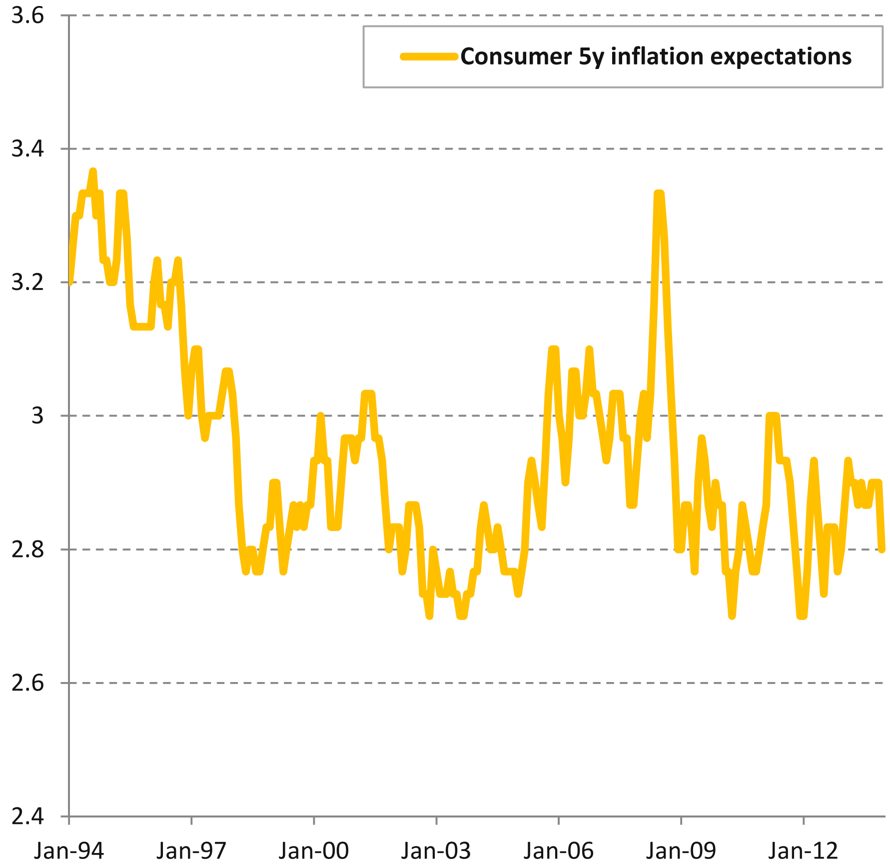

Shelter
7
6
5
4
3
2
1
0
-1
Jan-90
Jan-95
Jan-00
Jan-05
Jan-10


Energy
40
30
20
10
0
-10
-20
-30
-40
Jan-90
Jan-95
Jan-00
Jan-05
Jan-10

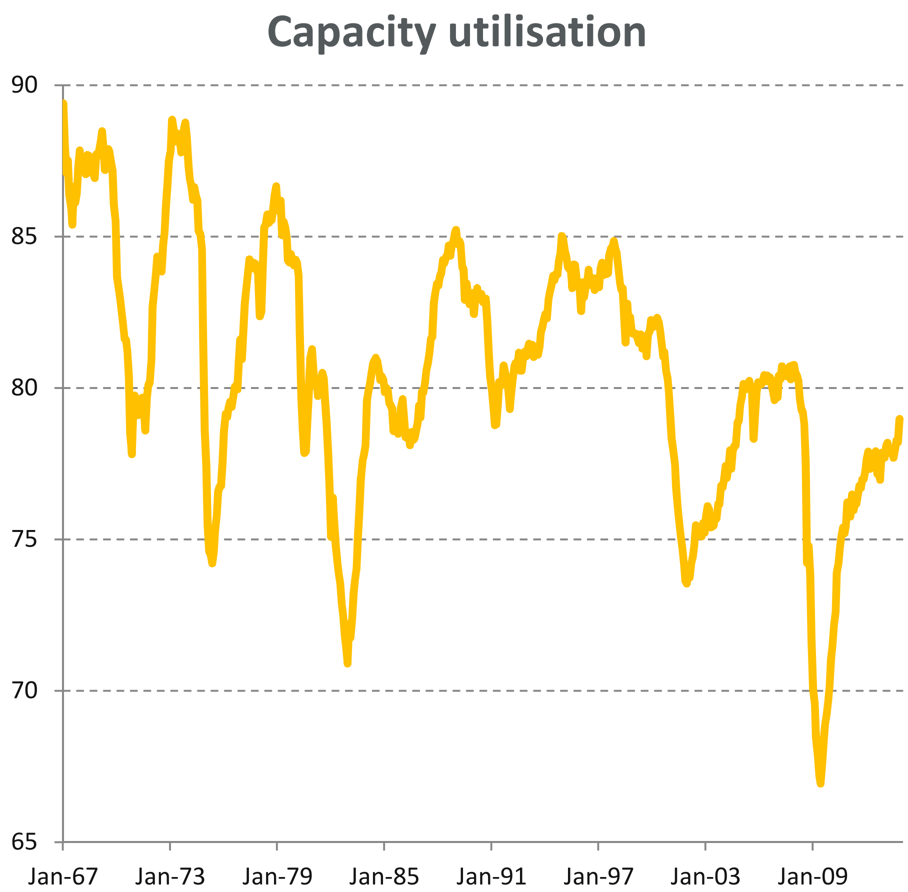

Food
8
7
6
5
4
3
2
1
0
-1
-2
Jan-90
Jan-95
Jan-00
Jan-05
Jan-10

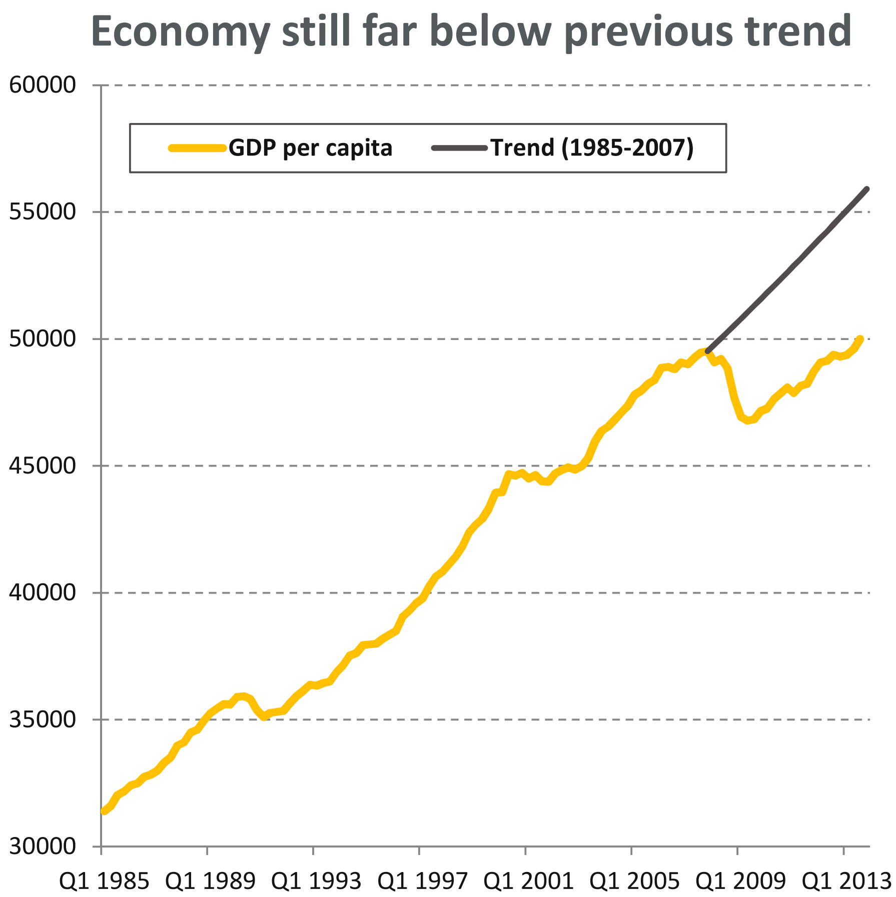
Inflation expectations remain modest





Slack in the economy?



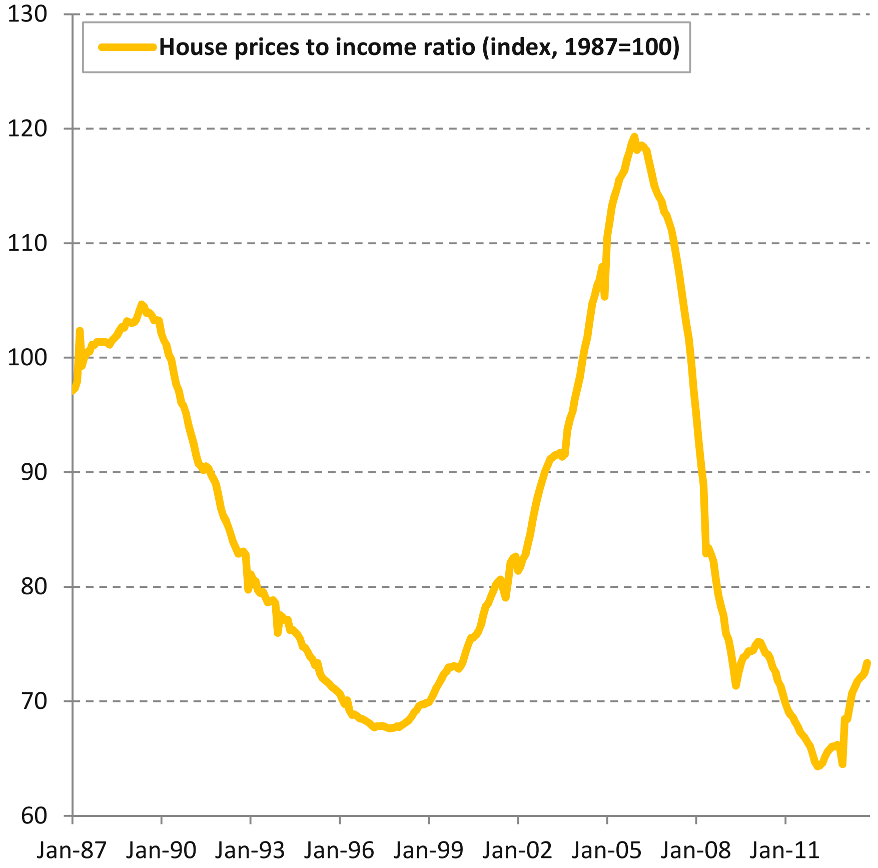


Key issues for the Fed: inflation

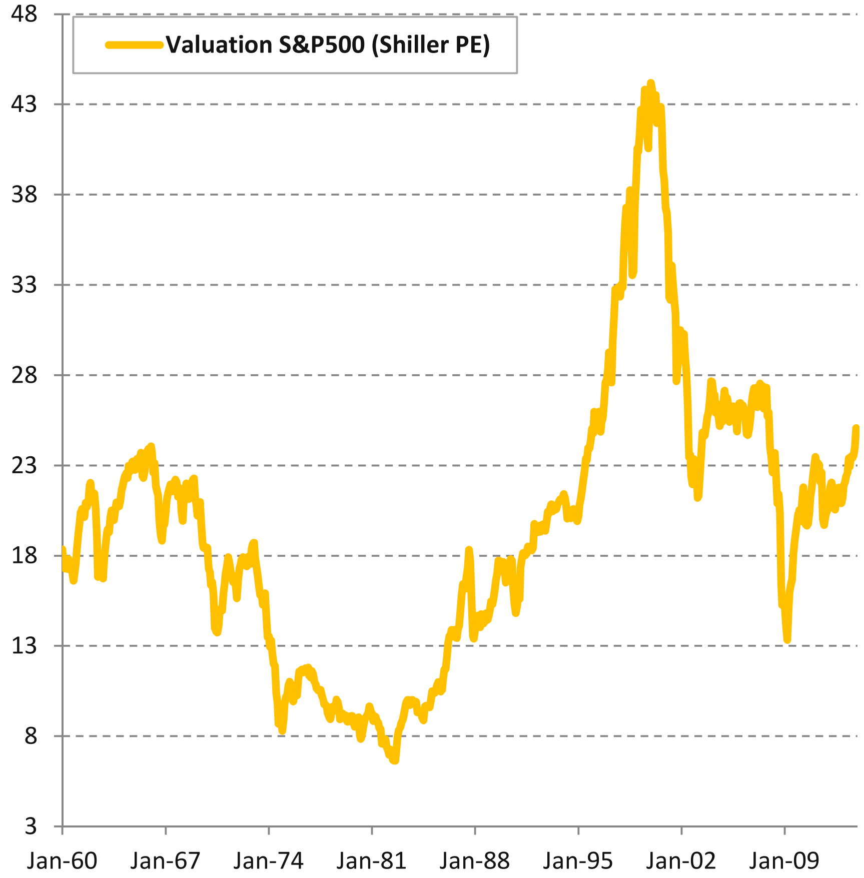
- In theory, money printing leads to higher inflation
- The extra money is still not really used
- Inflation remains quite low
- Inflation expectations are very well behaved
- Ample slack in the economy should keep inflationary pressures at bay for quite some time

Bubbles?

US real estate



US equities



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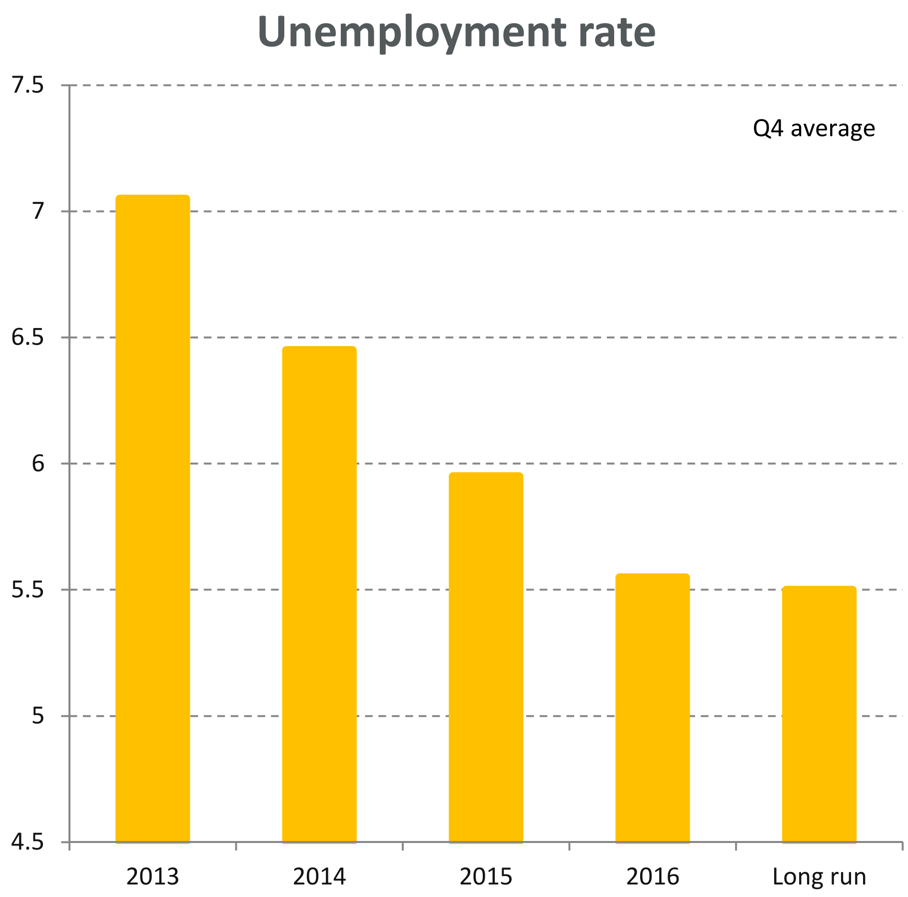
Key issues for the Fed: bubbles

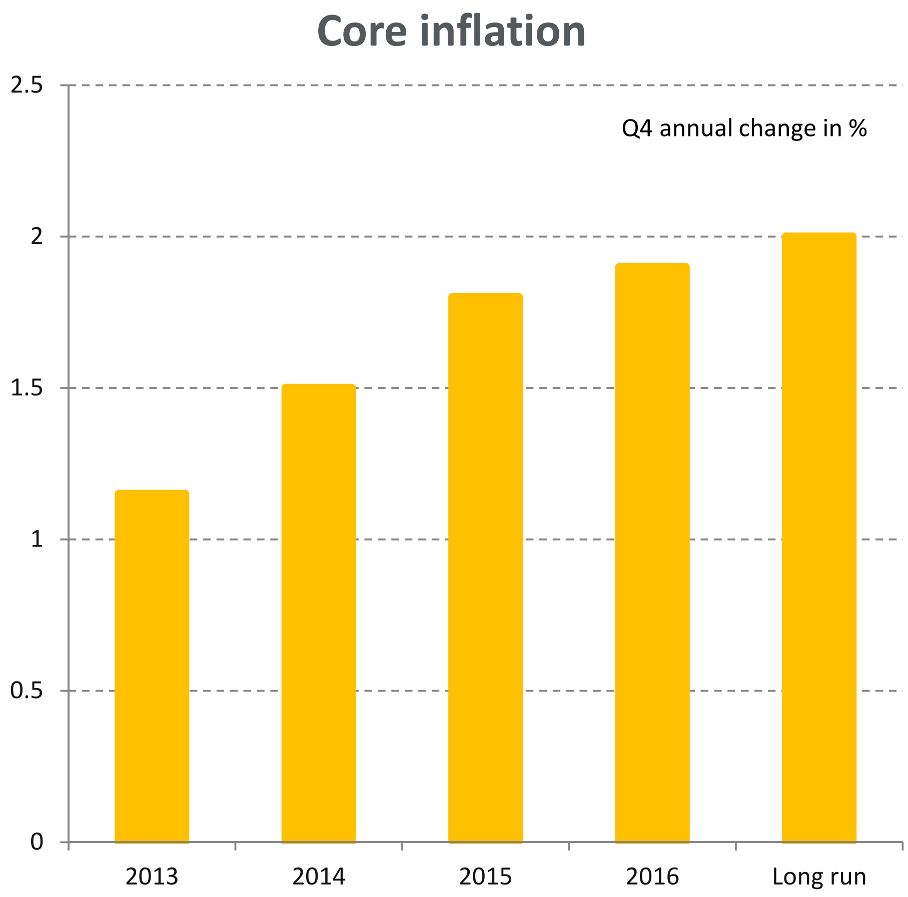
- Extremely loose monetary conditions could lead to new bubbles
- For now the major asset classes do not seem bubbly
- Still, bubble risks are increasing as the recovery proceeds and confidence is picking up

Long road back to normality for monetary policy

- Stop QE
- Stop rolling over maturing securities
- Actively reduce the balance sheet
- Raise policy rate

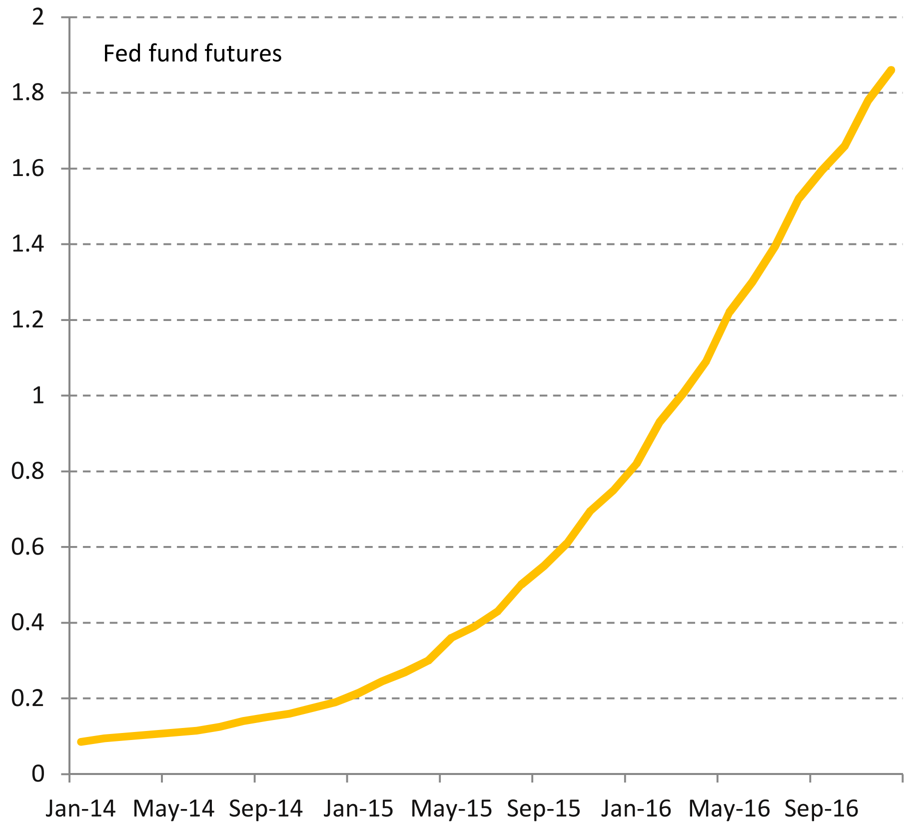
Fed economic expectations



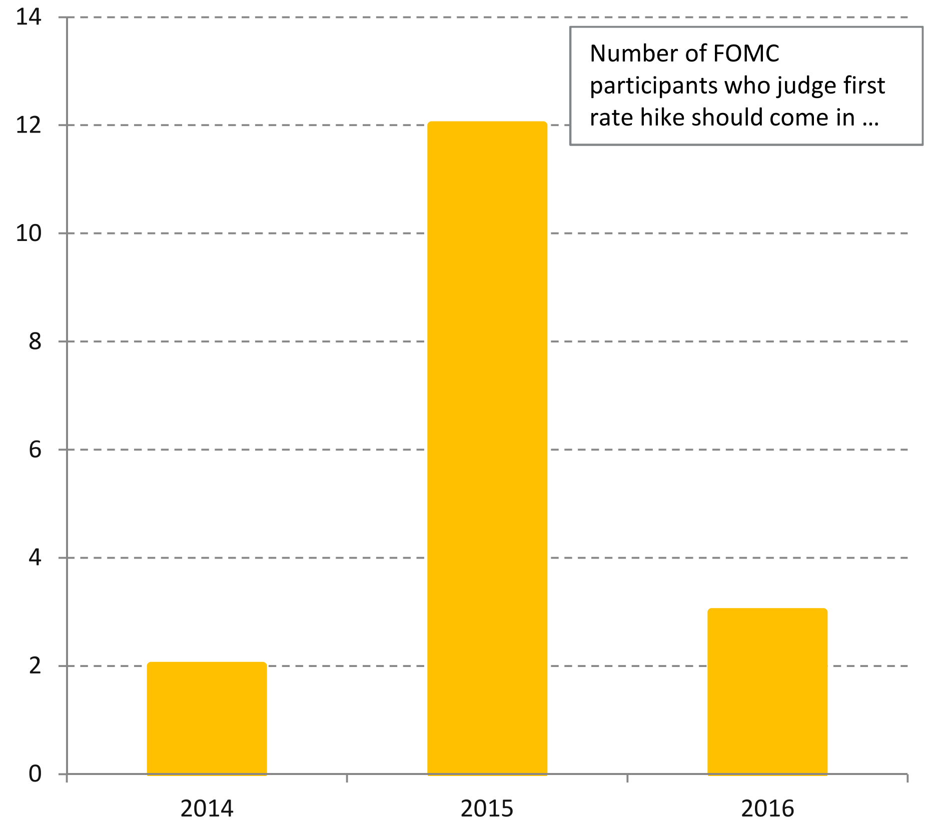


Expectations for the Fed policy rate

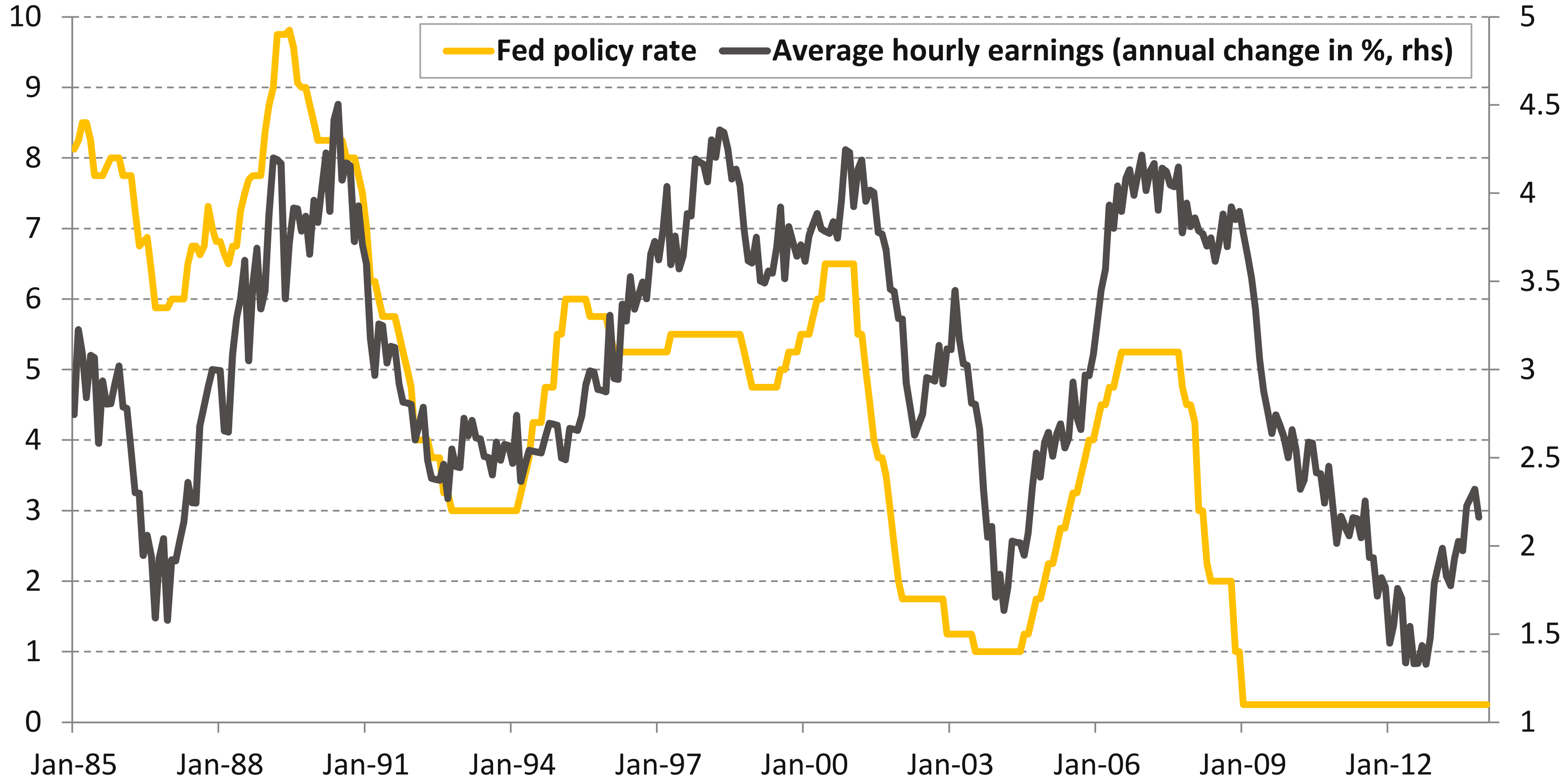
Market



Fed



In the past, Fed started hiking when wages started to increase



Outlook for the Fed

- As the recovery looks set to continue, the Fed will proceed with tapering: we expect QE to end in July

- In H2 2014, we expect the Fed to stop reinvesting the returns on its holdings, which would start a gradual, but slow reduction in the balance sheet

- First rate hike is expected for mid-2015

- The Fed will try to limit upward pressure on longer term interest rates through its forward guidance. At some point, the Fed is likely to have to add some actions to that (a new operation Twist seems likely)

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Upward risk for US yields limited