U.S. Fed Flash

Expect Fed to Announce Start to Taper on September 18th

- **Fed to announce modification to Treasury purchases**
- **Delay of a tapering announcement will put upward pressure on long-term interest rates**

There will be plenty Fed communications to digest when the September meeting ends Wednesday. The meeting will likely result in a Fed statement with changes in the balance sheet policy on asset purchases, revised economic projections and, of course, the much-awaited Chairman's press conference. Notably, prior to the September meeting FOMC governors have been quiet, making no speeches and Bernanke's last public appearance was his July 18th congressional testimony.

We expect the main policy change to be modification of Treasury purchases from $45bn to $40bn. There will likely be minimum statement changes, with forward guidance remaining the same, but the Fed will sneak in a $5 billion Treasury purchase decrease. Fed policy communication will emphasize continuance of the asset purchases rather than focusing on the taper. The statement will likely read: "To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee decided to continue purchasing additional agency mortgage-backed securities at a pace of $40 billion per month and longer-term Treasury securities at a pace of $40 billion per month."

The paragraph guiding the FOMC plan for asset purchases that states: *"The Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation ... In determining the size, pace, and composition of its asset purchases, the Committee will continue to take appropriate account of the likely efficacy and costs of such purchases as well as the extent of progress toward its economic objectives"* – will remain unchanged to leave the door open if the third quarter economic numbers disappoint due to debt ceiling brinkmanship, weak employment, or low inflation.

The trend in Fed's economic projections is that while its GDP growth projections are known to be overly optimistic and are usually revised down, its unemployment rate projections recently understated the speed of decline in the unemployment rate. We expect the Fed to revise GDP growth downward and leave unemployment and inflation unchanged. The August report for unemployment rate was at 7.3% and we expect it to average 7.5% for 2013, while annual GDP growth for 2013 is expected to be 1.8%. Bernanke will likely address the arising discrepancies between new projections and the policy action in the press-conference, and point out to high optimism in 2014 outlook.

Investors have already priced in Fed tapering in their expectations and many tend to discount the worst-case scenarios of a fast pace wind-down. After the news of the taper announcement settles down, and the market senses more certainty, that could take pressure off interest rates – bringing a slight downward movement of the upper end of the yield curve. The delay of a tapering announcement by the FOMC will increase uncertainty and continue putting upward pressure on long-term interest rates. It will create further volatility in the equity and bond markets, given that most investors expect the FOMC to announce start tapering in September.

Delaying the announcement until December questions the Committee's commitment to reducing Treasuries and mortgage back securities purchases in measured steps. By December, the much-anticipated news about who will replace Bernanke will already be public knowledge. More than half of the Committee's voting members will leave in 2014, and two of the incoming rotating Federal Reserve Bank presidents – Richard Fisher and Charles Plosser - are known for their hawkish views. Investors will be dissecting each Fed board nominee's past statements to guess who will cast hawkish versus dovish votes.

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