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COMMENTARY

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No Taper, Rates and Fed Credibility Fall

The FOMC surprised just about everyone with its decision not to reduce asset purchases at this time. Markets reacted immediately and violently with equities, bonds, and commodities surging and the dollar falling on the announcement.

The 10 year Treasury yield dove on the news and now hovers around the floor of its recent trading range of about 2.70%.

Source: Bloomberg Intraday 9/18/13

Careful what you wish for… Chairman Bernanke's legacy will be complicated, but surely marked by his efforts to reduce market volatility by communicating clear policy expectations. Bernanke paid the price for this yesterday as markets had lined up with confidence based on the expected Fed path and gave him no wiggle room for policy changes. Based on Bernanke's stated interpretation of the data, he had two unpleasant options yesterday: (1) go ahead with tapering to preserve Fed credibility or (2) reverse course and risk the backlash we ultimately observed. In his press conference, the Chairman struggled to connect the dots from his June expectations to the reversal of September, and failed to sufficiently convey the Committee's decision-making framework.

Consequences, near and far… The immediate consequences of yesterday's reversal are muted by the rally across most financial assets (except the dollar). Thus, Bernanke has largely been spared the investor ire that followed his introduction of Taper back in May. However, the Fed may have lost some of its credibility as the dominant force for market stability.

The Fed has consistently come up short on growth objectives and expectations despite unprecedented efforts at stimulus. The Wall Street Journal shared this chart this morning:

This track record, coupled with a summer of unpredictability, leaves us asking if the Fed can responsibly communicate its objectives and decision making framework.

What's an investor to do? It's cliché to advise investors to think long term, but this week reminds us not to lose sight of this basic investment tenet. Bernanke's transparency efforts lulled investors into a false sense of confidence about policy and near term direction. However, we have long viewed this Fed's transparency as laced with unattractive consequences, and this recent episode reinforced that strategies should be driven by economic fundamentals, market sentiment, and broader Fed goals.

Our base-case outlook calls for a lazy economic recovery that at some point triggers the removal of Fed accommodation and brings us into the next tightening cycle. We believe bond investors should continue building a defense (shorter maturities) or investing nimbly (active duration management). Near-term uncertainty continues to swirl around the DC political circus and the nascent housing recovery's effort to shake off this summer's rate move. Unfortunately, Fed 'contradictions' are now adding to the uncertainty that Bernanke aspired to reduce.

So don't rely too heavily on Fed Speak. This Fed has not accomplished the goals it has set and now may not be able to hold onto the expectations it communicates. Central Bank developments remain important but are only a piece of the larger picture. We expect the Fed will be more careful about 'possible' policy initiatives in the future, and markets will likely (hopefully) return to the assessment of fundamentals. In the end, the bond vigilantes of the mid 1990s may reemerge to demand a fair cost of capital for holding our nation's sovereign debt.

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