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ECONOMIC TALKING POINTS

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QE Is History, And Rightfully So. What To Focus On Next?

In perhaps its most delicately crafted FOMC statement in years, the Fed ended QE (hardly any surprise), yet kept the phrase on holding the target fed funds rate at its low level for *"a considerable time"* (which was also expected this time). The goal here was to avoid jolting global financial markets with the announcement that QE, after six years, has come to an end.

Two interesting points of emphasis emerged in the latest Fed's statement. Policymakers pointed to *"lower energy prices"* as one of the main factors that has kept inflation stuck below the 2% target, even though the economy was *"expanding at a moderate pace."* This tells us there is probably less concern at the Fed of the US slipping into the dangerous swamp of deflation.

The Fed also went farther than ever in saying that the slack in the labor force was finally shrinking. "*On balance, the range of labor market indicators suggests that underutilization of labor resources is gradually diminishing."*

It hammered home a related point two paragraphs later with sentences that we believe strongly hint an end to the "considerable time" at the December FOMC meeting.

"The Committee judges that there has been a substantial improvement in the outlook for the labor market since the inception of its current asset purchase program. Moreover, the Committee continues to see sufficient underlying strength in the broader economy to support ongoing progress toward maximum employment in a context of price stability."

We were also struck by the fact there was no specific mention of Europe's weakness or of the recent downward forecasts of global economic activity. This tells us that Yellen believes the US economy has effectively decoupled from the rest of world economy for now--- and that monetary policy will be based entirely on employment and inflation trends here in the US

As for the curtain closing on Quantitative Easing, let me raise a few points.

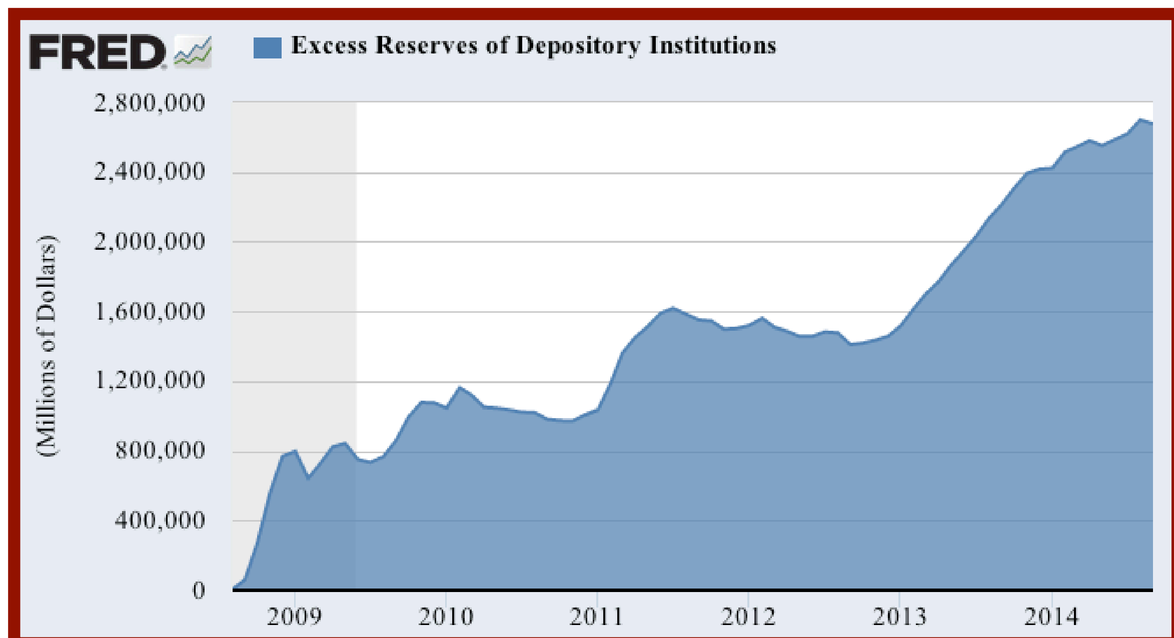
First, it is time to celebrate its end. The moment has clearly come to take the monetary training wheels off the economy, and here's why. We have to make a distinction between the normalization of interest rates (that is, where should market rates properly be given the state of the current economy?) ---versus--- a monetary policy that lifts interest rates with the specific intent to cool business activity out of concern for rising inflation.

The time is right for the former. The training wheels should come off now that growth and employment are back on track. The economy has been expanding at 3% or better in four of the last five quarters (if you include this past third quarter) and with payrolls this year climbing at the fastest pace since 1999.

The latter, where interest rates rise as a matter of policy to actually dampen growth, is something we do not foresee until 2018 at the earliest!

Second, from a practical matter there was no justification for continuing QE. None!

If the goal of QE was to keep the cost of capital low enough to encourage more private investment and hiring, the Federal Reserve has gone as far as it can. Short term rates remained close to zero, 10 yr Treasuries have held below 2.5% and mortgage rates are under 4%. Moreover, banks are swamped with nearly $3 trillion in excess reserves, a massive amount of funds that can potentially be converted into private loans at will. Given these historically low borrowing costs and the current economic rebound, there was no rationale whatsoever to extend the current round of QE, or launch a fresh one.



Third, another important goal of QE was to help drive unemployment lower. It worked quite well. When the current third round of QE began in September 2012, the jobless rate stood at 7.8%. It has since dropped to 5.9%, which puts it a few tenths of a point above what is believed to be non-inflationary full employment. We believe the Yellen Fed has now gone about as far as it can using the levers of monetary policy to reduce cyclical unemployment.

Does this mean the challenge of reducing joblessness is over?

Of course not. We still have 3 million who have been out of work for more than 6 months (and still actively looking), another 7 million forced to work part time because they can't find suitable full time work, and 5.8 million who do want a job but left the labor force out of frustration.

These are all significant numbers and a segment of the population that must not be ignored. But I believe these numbers increasingly reflect the quagmire of structural unemployment, those who lack the skills and experience employers seek. However, this is a problem that falls completely outside the purview of the Federal Reserve.

No central bank can fix the problem of a mismatch in skills. The Fed can't create programs designed to train the unemployed so they become more marketable. All the Yellen-led Fed can do is provide the economic backdrop for employers to ramp up hiring, and it has been successful in that regard. The number of jobs that employers want to fill has jumped to 4.84 million in August (latest available), the most since 2001!! Employers may complain there is a scarcity among the jobless who have the necessary skills --- but that is not something the Federal Reserve can repair. Only fiscal policy, through retraining and the subsidization of various educational programs can make a dent here.

What's next?

With QE formally ending, investors and business leaders should now shift focus on two developments**: (1) Will the fundamentals of the US economy continue to improve? (They will.) And (2), how will this change the delicate dance between the Fed and the banks in managing how much of those $2.7 trillion in excess reserves gets converted into actual loans.**

If lenders view the extension of credit to consumers and businesses to be more lucrative than collecting the risk-free but sleepy 25 basis points, the Fed will have to lift rates sooner and more aggressively than first thought. **However, we believe banks will continue to focus the rest of this year and next on building up their capital and liquidity levels, and remain fairly cautious on extending new loans.**

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