

# RISI VIEWPOINT: TAPERING, NOT TIGHTENING

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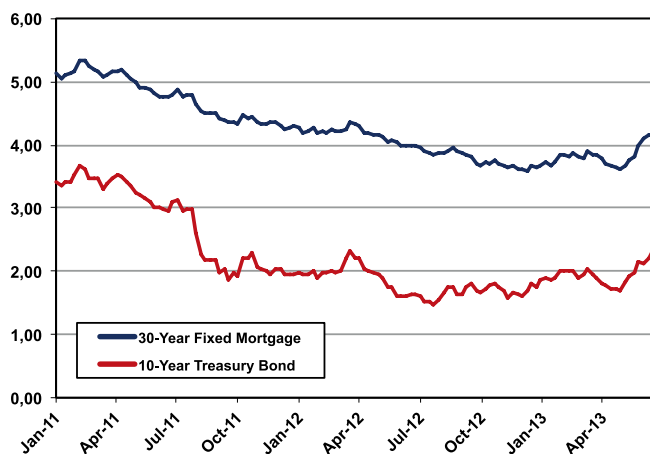
Chairman Bernanke upset the US and international financial markets at the end of May with statements that seemed to say that the US Federal Reserve was considering ending the current quantitative easing program. Under this latest iteration of QE, the Fed has been purchasing \$85 billion per month in US Treasury and mortgage-backed securities, which has had the effect of holding long-term interest rates down. But with indications that the program will start to be wound down, interest rates have started rising. A steady stream of Fed speakers came out to reassure markets that this tapering was not really tightening, but with little effect. So, is this really the start of monetary tightening by the Fed or are the markets overreacting? And whether it is or isn't, what effect will the higher rates have on the US economy?

While clearly the Fed is starting to reassess its quantitative easing actions, overall we do not think that monetary policy will become less accommodating in the near future, or that this action will have a serious negative effect on the US economy. The timing of the tapering will be very much related to the data on the health of the US economy. Ben Bernanke is a student of the Great Depression and knows very well the results of the monetary tightening that the Federal Reserve tried in 1937. He is unlikely to repeat that experience. Currently, the Fed has stated that it will continue with QE until the unemployment rate reaches 6.5% or inflation gets above 2.5%. With inflation actually going lower, employment will be the key measure. Last week's employment report and the revisions to prior months now show job growth averaging almost 200,000 per month. Should that continue or improve, and we expect that it will, it will put the Fed on track to start reducing their bond purchases by September of this year, when the economy should be on much stronger footing.

The main concern of the rising interest rates is clearly on what effect it will have on the housing recovery. At this point, with industrial production still weak and consumer spending still low by historical standards, housing is the key driver of the US economy. The majority of mortgage rates are tied to the yield on the benchmark 10-year Treasury bond, which has risen from 1.66% in early May to 2.73% at the end of last week. Mortgage rates have followed this increase (Figure 1) and are now at their highest level since August of last year - slightly above 4.5%.

Will this derail the housing recovery? We don't think so. While the 1 percentage point increase was certainly rapid, mortgage rates are still near historical lows. Over the past 40 years, they have been below 4.5% for only 19 months

**Figure 1. Mortgage Rates Follow 10-Year Bonds**  
30-Year Fixed Mortgage Rates; 10-Year Treasury Bond Yield



- the last 19 months. If mortgage rates do rise significantly more, we would have some more concern about housing, but we do not think that this will happen. Since they are based on the 10-year bond yield - about 2 percentage points above it - this will obviously be the key driver, and we do not see that yield rising significantly in the near term. Historically, the 10-year bond yield has never been more than 4 percentage points above the Fed Funds rate, which is currently set at effectively 0%. Until the Fed raises that rate, which we do not expect to happen until early 2015, 4% is the ceiling for the 10-year bond. The current quantitative easing is worth around 1 percentage point of yield, obviously decreasing as the Fed starts to reduce its bond purchases. Uncertainty around the world and the resulting flight to the safety of US securities is worth probably another 0.5 percentage point. All this adds up to a 10-year yield of 2.5% and mortgage rates around 4.5% - approximately where they are now.

Furthermore, as the economy improves, there will be less need for financing by the government - they will need to issue fewer bonds. If the Fed continued purchasing bonds at its current pace, it would be absorbing a greater percentage of the total bonds, i.e., monetary easing which it does not want to do.

So, why all the fuss about tapering? The rise in bond yields seems to be a bit of an overreaction by the market given the fundamentals. Sure, bond yields will rise gradually as the US economy strengthens, but as long as they do not rise faster than the improvements in the underlying economic conditions, they will not have a meaningful negative effect. Ben Bernanke will not kill the economic recovery. ■

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