



FOMC to get decidedly hawkish in 2011

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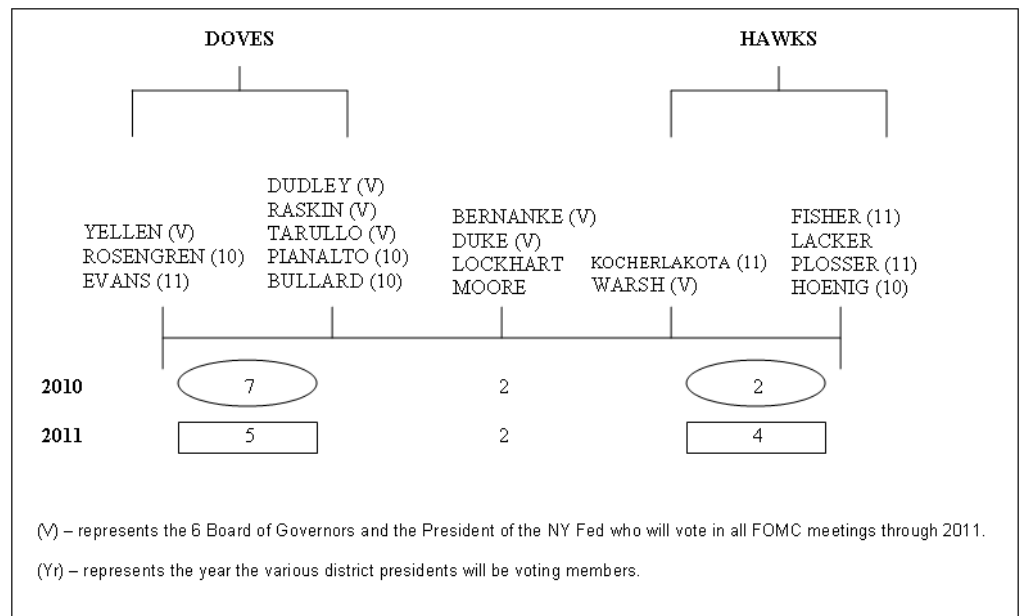
For several years the Federal Open Market Committee (FOMC) has been defined by the characteristics of its members who are often given the designation of 'dove', 'hawk' and somewhere in between based on their overall monetary policy bias. With a dual mandate of price stability and maximum employment the divergence between the bookends (hawks and doves) is determined by the priority placed on each objective within the mandate. Doves tend to focus on the maximum employment objective while hawks are focused on the Fed's credibility regarding long term price stability. In reality, there are more members of the Fed which tow the line between the two extremes. Where the members fall on this designation spectrum is typically a result of prior voting history and recent speeches given.

– New blood nods towards a shift in focus of the FOMC towards maintaining long-term price stability

– Real risk of current consensus view being jeopardised, possibly leading to the Fed's credibility being undermined

– Assets could come under pressure if the expected QE2 does not materialise and the window to act is narrowing fast

The board is comprised of the Chairman (Ben Bernanke), the Vice-chairman (Janet Yellen), up to five members of the Board of Governors, the President of the Reserve Bank of New York and four rotating presidents of the remaining eleven districts. The current FOMC structure is best described as dovish, as only two members of the voting committee are viewed as hawkish compared with a neutral or dovish tilt for the remainder of the members. Perhaps the most famous hawk of late has been Thomas Hoenig who has voted in objection to every FOMC meeting decision this year.



Source: Schroders



Schroders Quickview
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The current FOMC voting structure has only 2 meetings left (3 November and 14 December) to push through a second round of quantitative easing (QE2).

Beginning in 2011, three known hawks will enter the FOMC (Charles Plosser - Philadelphia, Richard Fisher - Dallas, Narayana Kocherlakota - Minnesota) decision making body. All three reaffirmed their hawkish tilt during recent speeches related to a second round of quantitative easing:

*"Thus, it is difficult, in my view, to see how additional asset purchases by the Fed, even if they move interest rates on long-term bonds down by 10 or 20 basis points, will have much impact on the near-term outlook for employment."*¹ – Charles Plosser

"In my darkest moments I have begun to wonder if the monetary accommodation we have already engineered might even be working in the wrong places." – Richard W. Fisher²

*"My own guess is that further uses of QE would have a more muted effect on Treasury term premia. Financial markets are functioning much better in late 2010 than they were in early 2009. As a result, the relevant spreads are lower, and I suspect that it will be somewhat more challenging for the Fed to impact them."*³ – Narayan Kocherlakota

The views, opinions and research of all the district presidents are used in developing the FOMC strategy and statement. So, the concerns of these three members have certainly been voiced throughout the year and are likely to be at the last meeting. However, the FOMC has created a fairly unified front in support of the consensus view (only Hoenig dissented). Starting in 2011, the FOMC votes could result in as many as three members opposing the strategy. While not unheard of in Fed history (it happened in 1991), it could undermine the Fed's credibility and caution foreign investment. The additional hawks on the committee lower the consensus to accommodate and add another element of uncertainty to the market.

Broadly speaking risk assets have already begun discounting a second round of monetary stimulus in the form of Large Scale Asset Purchases of Treasuries ("LSAP") or 'QE2'. Since 23 September treasuries are 10 bps lower in yield and risk assets have rallied (e.g. S&P 500 Index + 4%) all on the prospect of additional Fed stimulus. However, the market now expects quantitative easing at the 3 November FOMC meeting. If the Fed disappoints market participants, all assets could be under pressure (US dollar excluded). Moreover, the window to act may be closing as the FOMC composition shifts toward a more hawkish stance in 2011.

Schroders' US Fixed Income investment team believes that the Fed will explicitly signal some concrete plan to support asset prices at the 3 November meeting. However, the majority of this premium has been priced into the market and the risks for further upside is counterbalanced by comparable downside disappoint. We remain overweight spread product and higher beta sectors, but our exposures are significantly below levels earlier in the year. We intend to reduce risk as we approach the 3 November FOMC meeting and reassess the Fed statement and price levels at that time.

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¹ "Economic Outlook" by Charles Plosser, President and CEO, Federal Reserve Bank of Philadelphia; Remarks before Greater Vineland Chamber of Commerce; September 29th, 2010

² "To Ease or Not to Ease? What Next for the Fed" – Richard W. Fisher, President, Federal Reserve Bank of Dallas; Remarks before Economic Club of Minnesota; October 7th, 2010

³ "Economic Outlook and the Current Tools of Monetary Policy" by Narayana Kocherlakota, President, Federal Reserve Bank of Minnesota; Remarks before European Economics and Financial Centre; September 29th, 2010