Markit Economic Research

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United States

Fed tapers as outlook improves, removing one more global economic uncertainty

- **FOMC decides to start reducing its asset purchases from January onwards**
- **End to QE3 envisaged by end of 2014 if economy continues to improve**

The US Federal Open Market Committee started tapering its asset purchases at its December meeting.

Something that many overlooked – especially back in May, when talk of taper first appeared – is that the taper is not a tightening policy. It is merely a reduction in the pace at which the central bank is pumping money in to the financial markets. That total, which has been growing at $85bn every month since the Fed embarked on its third wave of Quantitative easing 15 months ago, will instead grow by $75bn per month from January onwards.

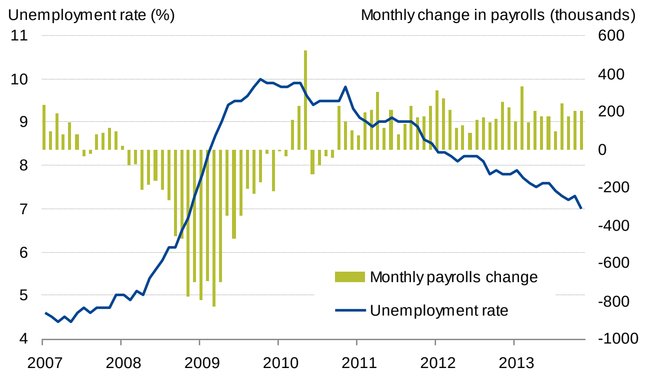
The third wave of QE was open ended, with the Fed committing to the monthly purchases until a "substantial improvement" in the labour market is evident. Such an improvement now appears to be occurring. The private sector has added an extra 193,000 employees on average in each of the past 12 months, which has picked up to 205,000 in October and November. Flash PMI data suggest that the private sector payroll count will have risen by at least another 200,000 in December. The unemployment rate has meanwhile fallen from 7.8% back in September of last year, when "QE3" commenced, to 7.0% in November.

If the labour market growth is sustained, the Fed is on course to continue tapering by $10bn per meeting, according to ongoing Fed chief Bernanke, bringing the additional purchases to an end by late next year.

However, anyone still fretting over the impact of the Fed cutting back on the amount of money it was injecting into the markets was offered comfort from Bernanke's reassurance that interest rates would not necessarily start rising until "well past the time" that unemployment fell below 6.5%.

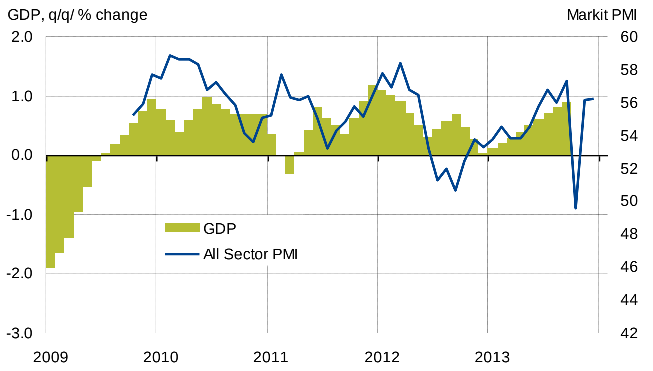
The Fed's decision comes at a time when a number of uncertainties about the domestic and international economies have been removed.

Non-farm payroll growth and unemployment rate



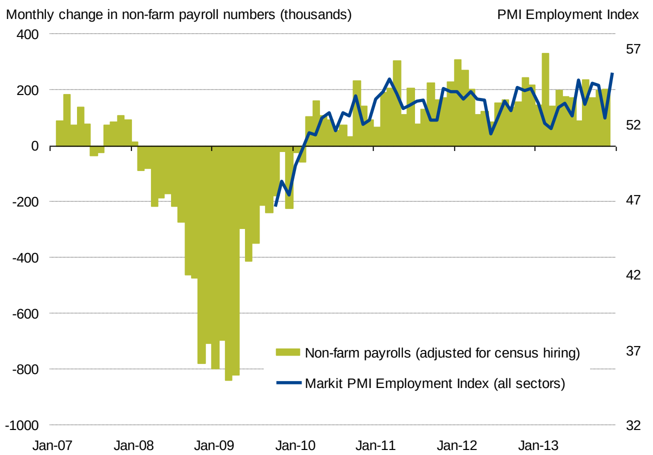
Sources: Markit, Bureau of Labor Statistics

'Flash' PMI and GDP growth



Sources: Markit, Bureau of Labor Statistics

Markit all-sector PMI Employment Index



Source: Markit, Bureau of Labor Statistics.

Fewer uncertainties

First, the US economy appears to have survived relatively unscathed from the government shutdown in October, with indicators suggesting that job creation and output were either largely unaffected or have since rebounded. Indicators are also suggesting that the pace of economic growth will have remained strong in the fourth quarter. Most recently, Markit's flash PMI data have pointed to a resilient annualised growth rate in the region of 3% for the final three months of the year. Politicians also appear to be paving the way for fewer fiscal-related disruptions next year, notably in relation to debt default and further government shutdowns.

Second, the financial markets wobbled severely after the initial talk of tapering was raised in May. More recently, however, markets have started to embrace good economic news in positive fashion. Whereas previously any good news caused an increase in risk aversion, as it increased the likelihood of a Fed taper, markets have recently been rallying on stronger economic news. This suggests that investors have begun to see the appropriateness of a tapering of asset purchases, and have grown more sanguine about the impact of any tapering.

Finally, the international economy is showing fewer signs of turning down again. PMI surveys are indicating a pick up in many emerging markets, notably China, as well as strong growth in the UK and Japan. Perhaps most importantly, the eurozone is showing signs of recovery. Although fragile, the upturn contrasts markedly with the steep rate of decline and worrying debt market crisis seen when QE3 was instigated in late-2012.

Good news for the global economy

The actual taper also removes one other uncertainty that has dogged the global economy. So far the US and international financial markets have greeted the taper positively. From an economic data perspective this looks appropriate and encouraging: the decision to taper reflects growing optimism in the health of the US economy and its ability to withstand a taper. The fact that a market wobble following the taper has so far been avoided also reduces one of the risks facing the wider, global economy.

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