

Bernanke Conference Provides No “Golden Ticket”

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This week, all eyes were on the Federal Open Market Committee (FOMC) meeting and Chairman Ben Bernanke’s inaugural news conference that followed. The surrounding hoopla reminded me of the search for the golden ticket in *Willy Wonka and the Chocolate Factory*. For those of you who do not recall the novel or its musical and film adaptations, it centers on Charlie Bucket and his search for a golden ticket that will provide access to Willy Wonka’s secretive candy factory.

While speeches and press conferences are not new to the Fed chairman, this one carried the promise and reward of the magical “golden ticket” that would unlock the secrets of the Fed. While we have seen similar post-meeting press conferences from the president of the European Central Bank, Jean Claude Trichet, they have not carried the same fascinating allure.

The goal, plain and simple, would be to be as transparent as possible. In theory, this would help guide the markets through a smooth transition as the Fed begins to end its current accommodative monetary policy. It would also provide insight into future Fed actions. It is something no other U.S. Federal Reserve Chairman has ever done.

Well, the conference is over. Unlike Charlie Bucket, investors found no magic in the Chairman’s words. His comments were, for the most part, in line with prior speeches and views. There was clarification that the FOMC was “going to continue to reinvest maturing securities, both Treasuries and MBS, so the amount of securities that we hold will remain approximately constant.” He continued, “Put another way, the amount of monetary easing should remain constant going forward from June.”

It can be said with certainty that the removal of accommodation will happen; the unresolved questions are when, how much and by which methods? The press conference marginally addressed these

concerns. What it did not address are the questions about what is creating the uncertainty in the financial markets and, more importantly, when the uncertainty will end.

The reasons for uncertainty are clear: geopolitical unrest in the Middle East and North Africa, elevated commodity prices, the unfortunate natural disasters that hit Japan and the ailing U.S. labor markets. These are the uncertainties that plague not only the strength of the U.S. recovery, but the global recovery as well. These are also the concerns that will likely keep Mr. Bernanke and the Fed cautious and sidelined longer than some feel is warranted.

In any event, before the Chairman embarks on raising interest rates or removing accommodations, there are a few steps that he and his Committee will need to take to lay the groundwork:

1. First off, the overall economic assessment needs to be changed. Currently this stands at “Risk to Growth.” This needs to be changed to reflect a more positive environment or concern about inflation. In the past the Fed has used “Inflation Risk,” “Balanced,” “Neutral” and “Tightening.”
2. Next, the Fed needs to shrink its portfolio. This task will likely have to happen prior to any rate hikes. This can be accomplished through different methods, either asset sales or halting the reinvestment of coupon payments. We would expect the halting of reinvestments to commence first. Even so, there will likely be a time period after the end of quantitative easing during which the Fed will hold its balance sheet stable before allowing it to passively wind down.
3. The removal of the “extended” period language (when referring to low interest rates) needs to take place prior to any rate hikes. This language has been at the heart of many discussions over the past couple of years. The likelihood of this changing is slim.

The ongoing rhetoric from the FOMC complicates matters. It is fair to say that the room is divided, and that the division is between the doves and the hawks. It is an age-old battle that wages on but gets more airtime near policy turning points. The FOMC remains slanted to the dovish side. Therefore, the voting members are likely to take the cautious approach. The wait-and-see mentality will prevail, unwilling to compromise on recent positions (such as not to risk derailing the economic recovery by removing accommodation too soon).

In the end, there are different measures and ways to interpret what defines the removal of policy accommodation. The change in investment behavior or even a change in language may be viewed as a shift in policy. This minor shift has the tendency in a short period of time to snowball into a more pronounced shift which will at some point ultimately lead to higher interest rates and a higher fed funds target rate.

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