Federal Reserve Eyes End of Bond Buying, Spooking Markets

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In a news conference, Federal Reserve Chairman Ben Bernanke talks about current monetary policy and situations that would lead to a change in those policies. Photo: AP.

Federal Reserve Chairman Ben Bernanke said the central bank could start winding down its $85 billion-a-month bond-buying program later this year and end it altogether by mid-2014, setting up a high-stakes test to see if the economy and financial markets can begin to stand on their own.

Financial markets—which have been enlivened by the fuel of the Fed's easy-money policies—didn't take the news happily. The Dow Jones Industrial Average finished the day down 206.04, or 1.35%, at 15112.19. Yields on 10-year Treasury notes jumped 0.126 percentage point to 2.308%, the highest level since March 2012. The dollar strengthened. Asian markets moved lower in early trading Thursday.

Behind the Fed's strategy for unwinding its bond-buying program were its optimistic new economic forecasts for next year, including a projection that the jobless rate, which was 7.6% in May, will fall to between 6.5% and 6.8% by the end of 2014.
The Fed hasn't yet made a formal decision to end the bond-buying program, and Mr. Bernanke in a press conference following the Fed's two-day policy meeting emphasized that the central bank will be flexible as it assesses the economy's health. The Fed's bond-buying programs are meant to drive down borrowing costs, push up asset prices and encourage more investment, spending and hiring in the broader economy.

But Mr. Bernanke said the wind-down could begin "later this year" if growth picks up as the Fed projects, unemployment comes down, and inflation moves closer to the central bank's 2% target. If those expectations bear out, the Fed could stop buying bonds altogether by the middle of next year, when officials project unemployment to be around 7%, he said.

**Fed Sees Faster Growth**

The Federal Reserve projects that the unemployment rate could fall to 6.5% in 2014, a threshold it has conditionally set to begin raising interest rates.

"The fundamentals look a little better to us," Mr. Bernanke said. "In particular, the housing sector, which has been a drag on growth since the crisis, is now obviously a support to growth." Rising home prices are increasing household wealth and strengthening consumer confidence and spending, he noted.

Fed officials have been signaling for several weeks that they see underlying strength in the economy, even though growth was soft in the first half of the year. Mr. Bernanke, in testimony to
Congress last month, said the Fed could start pulling back on the bond-buying programs later this year, sending shudders through many investors who had expected them to continue longer.

Moreover, the Fed said in its postmeeting statement that risks to the economy were diminishing. Last year, Fed policy makers were worried Europe's financial market and fiscal woes would ricochet to the U.S. and concerned about the impact of U.S. tax increases and spending cuts. They are now less worried about Europe and encouraged that the U.S. economy has held up under fiscal headwinds at home.

Two Fed officials dissented from the policy statement for opposite reasons. St. Louis Fed president James Bullard dissented because he thinks the Fed should be tilted toward easier monetary policy in light of low inflation, while Kansas City Fed president Esther George cited concerns that continued bond-buying could destabilize financial markets and push longer-term inflation expectations higher.

The Federal Reserve’s policies impact everyone from Washington to average household income to the financial and real estate sectors. Mark Calabria, Director of Financial Regulation Studies at the Cato Institute discusses. Photo: Getty Images.

Some executives share the Fed's optimism. Michael Jackson, chairman and chief executive of AutoNation Inc., AN -1.25% the largest auto retailer, sees the economy on stronger footing.

"The fundamental message is the U.S. economy is in a self-sustaining recovery, and we can move away from these extraordinary measures," said Mr. Jackson, who is on the board for the Miami branch of the Atlanta Fed. "I'm not afraid of normalized rates that will unfold over the next year or two…you can't be on the juice forever."

Noah Wilcox, president and chief executive of Grand Rapids State Bank in Minnesota, welcomed the news that the Fed is thinking about scaling back its bond buying. "It's overdue, quite frankly," said Mr. Wilcox, the fourth generation of his family to run the bank, which has assets of $250 million.

The Fed's easy-money policies have hurt profitability for small banks like his, squeezing the difference between what they earn when they borrow from depositors and then lend or invest those funds. Reducing the bond purchases should allow yields to rise on the fixed-income securities that banks hold in their own portfolios, said Mr. Wilcox.
But some investors worried Mr. Bernanke’s plans could hurt the housing market by driving up mortgage rates. “I think that he will be very disappointed by the response of the markets to his comments,” said Scott Minerd, chief investment officer at Guggenheim Partners, a Chicago-based investment management firm with $180 billion in assets under management. “The Fed has created an artificially low mortgage rate. Without that below-average mortgage rate, which housing is entirely dependent upon, the housing recovery is going to slow down.”

The latest uptick in Treasury rates led to selling throughout fixed-income markets, from mortgage-backed securities to highly rated corporate bonds.

**Agilent Technologies** Inc A -2.86% , which issued debt on Tuesday, saw its bonds due July 2023 trade at 97.193 cents on the dollar, down from 99 cents earlier in Wednesday’s session, according to MarketAxess data.

Longer-term bonds were hit harder. Bonds due in 2038 from General Electric Capital Corp., a funding arm of industrial conglomerate **General Electric** Co., GE -1.44% traded at 5.152%, compared with 5.044% earlier in Wednesday’s session. Prices fall as yields rise. Those higher yields could in turn squeeze borrowers.

The Fed has been disappointed continually in this recovery, often overestimating how fast the economy would grow. On two previous occasions it ended bond-buying programs only to restart them later when officials concluded the economy needed more stimulus.
Fed Statement Tracker

Compare any two statements since 2007.

Fed officials are now a bit more optimistic than private forecasters. The Fed projects growth of 3.0% to 3.5% growth in 2014, faster than the 2.8% growth rate projected by forecasters surveyed by The Wall Street Journal earlier this month. Its projection of an unemployment rate of 6.5% to 6.8% at the end of 2014 is in line with private forecasters' projection of 6.7%.

Mindful of the risk that the Fed could prematurely unwind its easy-money policies again, or that it could unsettle the markets with even small steps, Mr. Bernanke sought to keep his options open. "Our purchases are tied to what happens in the economy," he said. "If the Federal Reserve makes the same error and we overestimate what's happening, then our policies will adjust to that."

Fed officials sought to reassure investors in other ways that they weren't going to slam on the brakes of monetary policy. Ending the bond-buying program would be a first step toward unwinding easy-money policies, but other steps, such as raising short-term interest rates from near zero, aren't likely until much later.
Even though they see the jobless rate coming down faster than before, 15 of 19 Fed officials said in a survey released by the central bank Wednesday that they still didn't expect to start pushing up short-term interest rates until 2015. Moreover, Mr. Bernanke said the Fed is unlikely to sell down its large mortgage portfolio—a switch from its previous plans meant in part to soothe the worries of bond investors. Instead, the Fed is moving toward a strategy of allowing the mortgage bonds to mature and gradually wind down on their own.

Since last September, the Fed's holdings have expanded from $2.8 trillion to $3.4 trillion. Officials believe that by gobbling up so many mortgage bonds, it has helped to drive up their prices and drive down their yields, and at the same time driving investors into other assets such as stocks.

Though the Fed and other central banks like the Bank of Japan 8301.JA -3.68% and the Bank of England believe their bond-buying efforts help to stimulate economic activity, the central bankers have a wide range of skeptics, including former Fed chairman Alan Greenspan.

In an interview with The Wall Street Journal Tuesday, Mr. Greenspan noted that the Fed is pumping money into the financial system but banks aren't lending this money out, muting the impact of Fed policies. "Very little of it is leaking out into the [financial] system," he said. "It just as well can be zero."

Looming over all of these challenges is a succession drama set to play out in coming months. Mr. Bernanke is widely believed to want to step down from the Fed when his term as chairman ends next January. President Barack Obama acknowledged as much in a television interview earlier this week. That means the Fed is on track for a potentially unsettling leadership change as it tries to navigate a delicate withdrawal from its current stance.

Mr. Bernanke declined to discuss his future.

"We just spent two days working on monetary-policy issues," Mr. Bernanke said. "I don't have anything for you on my personal plans."

—Katy Burne contributed to this article.

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