Fed Stays the Course on Bond Buying

Officials Leave Investors on Tenterhooks About When They Will Wind Down Program

By

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The Federal Reserve's July policy minutes sent markets on a ride Wednesday afternoon. Steve Russolillo joins The News Hub with a look at the market's confused reaction as it hedges when the central bank will begin tapering. Photo: AP.

Federal Reserve officials reaffirmed their plan to try winding down an easy-money program that has charged up global markets but left investors on tenterhooks about when or how aggressively they would move.

Minutes of the Fed's July 30-31 policy meeting, released Wednesday, suggested officials were on track to start winding down the $85 billion-a-month bond-buying program, possibly as early as September, if the economy strengthens as they expect.

They were, however, a bit more uncertain than in June about whether economic growth would pick up as they forecast and about the gains they were seeing in the job market.

Reflecting the cautiousness shown in the minutes and their own uncertainty about how the economy will perform in the months ahead, some Fed officials have begun talking about making a small move when they do start pulling back on bond buying. "If you're very uncertain about how strong the improvement in the economy is, and how self-sustaining, then you should move in fairly small increments," Eric Rosengren, president of the Federal Reserve Bank of Boston, said in an interview Wednesday with The Wall Street Journal.

Mr. Rosengren, a strong supporter of the easy-money policies, said he was still forming a judgment about whether the economy was improving as expected. "This is a good time to be patient and very watchful," he said.
The presumed exit of Fed chief Ben Bernanke when his term ends in January is adding to policy uncertainty.

The Fed's deliberations—and its sometimes confusing efforts to publicly signal how officials are thinking—have roiled global markets in the past few months, pushing up U.S. interest rates and knocking down emerging markets, which initially benefited from the Fed's easy-money policies.

Wednesday's market movements mirrored the broader turmoil and investor confusion. U.S. stocks initially dropped after the minutes were released at 2 p.m. New York time, then moved higher and tumbled again as investors tried to make sense of the report.

Yields on 10-year Treasury notes rose to 2.85%, extending a surge from 1.66% in early May when bond investors began considering the prospect of the Fed reducing its support for the market. Rates on 30-year fixed mortgages were 4.70% on Tuesday, up from 3.56% in early May, according to Bankrate.com.

Underscoring the market uncertainty on the fate of the Fed's bond-buying program and the impact on rates, investors have been pulling out of bonds. So far this month, according to TrimTabs Investment Research, investors pulled $30.3 billion from U.S. bond mutual funds, the third-largest monthly outflow in records going back to 1984. In emerging-market bond funds, investors have pulled out more than $26 billion since the start of June, according to fund-tracker EPFR Global.

To soften the blow to investors worried about the end of easy money, Fed officials have been trying to underscore their plan to keep short-term interest rates low long after they pull back on the bond-buying program, which is targeted at long-term rates. They discussed different ways to clarify this "forward guidance" about short-term rates at their July meeting but didn't take any new steps.

As is often the case, Fed officials had differing views at their July meeting about when to pull back bond buying. "A few (officials) emphasized the importance of being patient and evaluating additional information on the economy before deciding on any changes to the pace of asset purchases," minutes of the meeting showed. A few others "suggested that it might soon be time to slow somewhat the pace of purchases as outlined."
Interest rates had stabilized in July but shot higher in August as investors weighed the possibility that the Fed might move at the Sept. 17-18 meeting. Officials have just four weeks to make a judgment about moving then, and only a few more pieces of important economic data, such as a jobs report for August.

The Fed has been purchasing $40 billion per month of mortgage bonds and $45 billion per month of Treasury notes since last year in an effort to hold down long-term interest rates and drive investors into riskier assets such as stocks. The program is often referred to as quantitative easing.

The central bank has been trying for four years—many say in vain—to energize the limp U.S. economic recovery by encouraging borrowing, spending and investing with easy-money policies. The author of these policies, Fed Chairman Ben Bernanke, appears to be on his way out in January when his second four-year term ends. When officials gather at an annual Fed retreat in Jackson Hole, Wyo., beginning Thursday, Mr. Bernanke won't be there.

President Barack Obama expects to nominate a successor in the fall. Uncertainty about the central bank's next leader is adding to anxiety in markets and inside the Fed itself. Senate confirmation hearings loom and could lead to additional uncertainty about Fed leadership if Mr. Obama's choice faces resistance.

Against this backdrop, Mr. Bernanke is trying to engineer a complicated monetary-policy maneuver by beginning to wind down a program that officials believe has had some modest success boosting interest-sensitive sectors such as housing and autos, but can't go on forever. Mr. Rosengren noted that it is harder than usual for the Fed to send convincing signals about its plans for the future during a leadership transition.

Fed officials have said all along their decision on when to pull back on the program depends on the economy’s performance. Most notably, they want to see substantial improvement in the job market and steady 2% inflation. So far the data are mixed, complicating the Fed's task. Gross domestic product—the broadest measure of economic output—is growing around 2%, according to many analyst estimates, not fast enough to spur robust hiring.

Inflation by several measures has been running below the Fed's 2% goal, but many officials believe it will move back toward that target.

Firms added 175,000 new workers per month between May and July, according to Labor Department data. That is faster than when the Fed launched the bond-buying program a year ago, but slower than when officials started talking about pulling it back earlier in the year. Meanwhile, the unemployment rate fell from 8.2% in July 2012 to 7.4% last month, a big improvement.

But other measures—such as the relatively high number of people getting part-time jobs but wanting full-time work and a dearth of working-age Americans re-entering the labor force—suggest the job market remains weak.

"A number" of Fed officials "were somewhat less confident about a near-term pickup in economic growth than they had been in June," the minutes of the July meeting said. "Factors cited in this regard included recent increases in mortgage rates, higher oil prices,
slow growth in key U.S. export markets, and the possibility that fiscal restraint might not lessen."

Now, officials might have another problem to worry about. The persistent rise in long-term interest rates could start biting the housing sector just as it is getting back on its feet because higher rates raise the cost of purchasing a home.

"I think we're going to see slower housing growth than we anticipated," Curt Stevens, the chief executive of Louisiana-Pacific Corp., a construction-materials maker, said in an interview Wednesday. His firm has idled some plants amid softer demand. Some product prices are down 25% to 30%, he said. "Demand just isn't what we anticipated it to be."

The Fed's decision on when to start reducing bond purchases—referred to by some analysts as tapering—has grabbed the attention of people beyond Wall Street.

"I just met with some first time home buyers this evening," Brian Wickert, president of Accunet Mortgage, an underwriter, said earlier this week. "Without any prompting from me, they mentioned the Fed's tapering of quantitative easing as a factor inspiring them to buy as soon as they can."

Still, rising interest rates aren't necessarily an ominous development for the economy. Rate increases are often a sign of building demand in an economy and officials have said their own plans to step away from easy money depend on a stronger economy.

That desire by some home buyers to move quickly might be providing at least a short-term boost to home sales. The National Association of Realtors reported Wednesday that sales of existing homes jumped 6.5% in July from the month earlier and were up 17.2% from a year earlier.

"We believe there is a lot of pent-up demand, especially from move-up buyers," Steve Hilton, chairman and chief executive of Meritage Homes Corp., which sold 2,373 homes in the first half of this year, said in an interview on Wednesday. "I don't think the short-term rise in rates is going to have a lot of impact, except maybe for first-time buyers."

But the Realtors' economist had a warning.

"Mortgage interest rates are at the highest level in two years, pushing some buyers off the sidelines," Lawrence Yun, NAR chief economist, said in a release. "The initial rise in interest rates provided strong incentive for closing deals. However, further rate increases will diminish the pool of eligible buyers."

—Kris Hudson contributed to this article.

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