Fed Policy and Communications. Strong US Economy. Threats to the Recovery

As expected the Fed is prevaricating over its plan to slow the pace of QE. The Fed was always going to telegraph its intentions well in advance and to prevaricate publicly until the market was weaned off the idea of perpetual QE before they actually taper it off.

The fact is that the US economy is now on the path of self sustaining growth and therefore not in need of further QE. It is therefore rational for the Fed to slowly reduce the size of its balance sheet. Consider the analogy of a person in intensive care. This was the US economy in 2008. The Fed quite rightly prescribed morphine. Most analgesics are addictive, yet when there is recovery, the continued administration of morphine is not only unnecessary, it is harmful. And there is no way the patient can get up and walk out until it is weaned off the morphine. That the doctor feels that the patient is ready to go off the drug is good news not bad.

The markets have yet to come to grips with the Fed's withdrawal from QE and elevated volatility is to be reasonably expected. But he prognosis is positive. While equilibrium GDP growth may not revert to pre 2008 levels of 4%, a real recovery is underway evidenced by improvements in manufacturing, the labour market, household income, consumption and confidence. The post crisis equilibrium rate may have halved to 2% but corporate earnings have continued to be robust on higher productivity.

There will be threats to the new growth. Trade is likely to fall globally as each country tries to export their way to growth. Other regions in the world continue to see slowing growth from China to Europe. Asset markets reflect similar trends with the US and Japan bucking a trend of tepid returns and sometimes outright negative returns. China is a significant risk as its economy slows beyond expectations. Being the largest external holder of US treasuries is not very reassuring. The strong USD is also a brake on US exports. Fortunately much of the growth in the US appears to be domestically led.

The past few decades saw a surge in growth driven by credit and globalization. The bursting of the credit bubble has reset matters and to an extent rolled back globalization. The search for growth may now take a more insular and domestic turn. While the US is self sustaining threats remain from without, as the global economy readjusts to a less globalized state. The inequality between countries that converged in the past few decades may begin to widen once again. But if the inequality that has diverged to so long within countries is not reversed, the political and social stability of many a government may be challenged.