1. **Federal Reserve (Fed) Chairman Ben Bernanke's dovish surprise reaffirms that the Fed is "data-dependent" and that the Fed remains committed to providing accommodation until there is more progress towards its objectives.**

   Over the past few years, Chairman Bernanke has been remarkably consistent on two points: he watches the economic data very closely and he convinces the Fed to provide more accommodation when there are concerns about either labor markets or inflation. September 18th's big surprise—that the Fed has delayed tapering—was entirely in line with Chairman Bernanke's past performances. Recent economic data have been disappointing relative to the Fed's expectations and progress on the labor market and inflation has been frustratingly slow.

2. **In addition to the surprise announcement on asset purchases, there were at least two other parts of September 18th's Federal Open Market Committee meeting that were bullish for bond markets.**

   First, the Fed's guidance for the future path of the federal funds rate was more dovish than expected. In particular, the Fed anticipates that once it starts raising the federal funds rate, it will do so at a very gradual pace of 25 basis points per quarter. This is a slower pace than markets were pricing, and that has had the effect of lowering short-term interest rates, particularly those rates maturing in 2016.

   Second, in his press conference Chairman Bernanke reiterated a number of familiar themes that suggest that the Fed will remain accommodative for some time. This included emphasizing that the Fed would be slow to raise rates even if the 6.5% unemployment threshold were crossed.

3. **The bond market's reaction to September 18th's announcement reflects a number of considerations.**

   First, the Fed decision to delay tapering has changed the market's expectations for the eventual size of the Fed's balance sheet. The increase in expected Fed demand pushes up bond prices and pushes down yields.

   Second, by reaffirming that the Fed is "data-dependent," its decision on September 18th reduces uncertainty about the Fed's reaction function and dampens concerns that the Fed was being forced to stop providing accommodation. This should be reassuring to bond investors and should help lower the risk premium that has recently built up in bond yields.

   Finally, the announcement refocuses the market on economic data as the primary determinant of Fed policy. As mentioned, the hard economic data have been disappointing over the past few months. At the same time, recent sentiment surveys (especially the ISM surveys) have been more optimistic and may point to a coming acceleration. How these trends play out over the coming months will determine the Fed's next move.

4. **With the Fed remaining in a firmly accommodative stance for the time being, the next move in interest rates will be determined by developments in growth and inflation.**

   Our view is that growth is likely to remain sluggish and that inflation is likely to remain low. In an environment of sluggish growth and low inflation, bond yields are likely to remain at a lower level than where they have been trading for the past month or so.

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