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# Fed Remains Sidelined For Now

Contact:
Thomas D. Higgins, PhD
Chief Economist
**ph:** 213 830-4302
**email:** thiggins@payden-rygel.com

## Highlights

- Bond investors were disappointed that the Fed did not expand its $1.75 trillion credit easing program through additional purchases of US Treasuries.
- The Fed appears to be signaling that it is comfortable with the rise in long-term interest rates that has occurred since its April meeting.

The Federal Reserve left its benchmark federal funds rate unchanged in a range between 0% and 0.25% at the conclusion of its June policy meeting. The decision was widely anticipated, as was the central bank's affirmation that "economic conditions are likely to warrant exceptionally low levels of the federal fund rate for some time."

However, bond investors were disappointed that the Fed did not expand its $1.75 trillion credit easing program through additional purchases of US Treasuries. Consequently, 10-year yields rose from 3.57% just ahead of the policy meeting to 3.69% immediately afterward. By not increasing its purchases of US Treasuries, the Fed appears to be signaling that it is comfortable with the rise in long-term interest rates that has occurred since its April meeting. And why shouldn't it be? An increasing number of economic indicators point to an economic recovery in the second half of 2009 and the recent rise in yields has had little impact on private sector borrowing costs, both of which are the focus of the Fed's credit easing program.

Furthermore, if the Fed's outlook for inflation is accurate, then the back up in Treasury yields should prove self-limiting. In its policy statement, the central bank stated that "substantial resource slack is likely to dampen cost pressures, and the Committee expects that inflation will remain subdued for some time." The central bank is projecting that its preferred inflation gauge –the core personal consumption expenditures (PCE) deflator– will fall to between 1.0% and 1.6% by the end of 2010, down from 1.9% today. Historically, investors have insisted on a real return of around 2.0% on long-term Treasury bonds. Assuming this is still the case, a 2% real yield plus inflation of 1% to 1.6% would imply that fair value for the 10-year Treasury would be at a yield level between 3% and 3.6% in 2010, which is not far from where we are today.

### The Great Inflation Debate

But not everyone agrees with this viewpoint. Some Fed-watchers are concerned that the trillions of dollars being spent by the US government will result in a surge in inflation in the not too distant future. The most extreme view holds that the government will run massive deficits for the foreseeable future with the central bank monetizing these deficits by increasing purchases of US Treasury bonds. Such actions would then lead to an eventual collapse of the US dollar and a surge in inflation.

While such an inflationary scenario is possible, a long time lag typically exists between increases in the fiscal deficit and the impact on inflation and interest rates. Indeed, a study from the Fed found that a one percentage point increase in the debt to GDP ratio adds 4 or 5 basis points to 10-year Treasury bond yields, but only with a five year lag[1].

Much can change in five years, so it is difficult to draw firm conclusions about what the economic environment will be in 2014. Fed Chairman Ben Bernanke has gone out of his way to argue that the Fed will not monetize the debt and has advised Congress to begin thinking of ways to trim the long-term fiscal deficit. Only time will tell if policy makers heed this advice, but in the interim it may be worthwhile to consider other variables, including commodity prices and the output gap, which will have a more immediate and offsetting impact on the outlook for inflation.

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- Some Fed-watchers are concerned that the trillions of dollars being spent by the US government will result in a surge in inflation in the not too distant future.
- Even if the US economy begins an economic recovery in the second half of 2009, slack in product and labor markets is likely to keep downward pressure on the price level for some time.

### Commodity Prices and the Output Gap

Our inflation forecast for the next 3 to 6 months is primarily driven by commodity prices, particularly oil. Holding oil prices constant, headline consumer price inflation will swing from a year-to-year rate of -2% this July to +2% this December. The May inflation figures indicate this scenario is already playing out as expected with the headline CPI down 1.3% from year ago levels –its worst decline in sixty years. Core inflation, which excludes food and energy prices and accounts for roughly 75% of the overall price level, has remained much more sticky at +1.8% in May. This suggests that the drop in commodity prices is not significantly impacting the broader price level and that the deflation the US is currently experiencing will likely prove temporary.

The inflation outlook will get a little cloudier as we enter 2010. By that point, attention should begin to shift away from commodity prices and toward the output gap. Put simply, the output gap is the difference between how fast an economy is actually growing and the rate of growth it can achieve without generating inflation when its capital and labor resources are fully employed. The best real time measures of the output gap are capacity utilization, which measures slack in the industrial sector, and the unemployment rate, which measures slack in the labor market.

Neither indicator suggests inflation is a major threat. Capacity utilization stood at 68.2% in May, its lowest reading in the series' history going back to 1948. In the past, price pressures resulting from supply bottlenecks have only begun to emerge when utilization rates top 80%. Meanwhile, the unemployment rate has risen to 9.4%, its highest level since the early 1980s. During the last economic cycle, an unemployment rate of below 5% was considered inflationary. Today, the non-accelerating inflation rate of unemployment (NAIRU) may be quite a bit higher since those extraordinarily low unemployment rates were achieved with a large amount of leverage in the financial system that is probably not coming back for the foreseeable future. But even if we assume that the NAIRU is 6% or 7% today, there is still quite a bit of slack in the labor market that will keep wage demands at a minimum.

Therefore, even if the US economy begins an economic recovery in the second half of 2009, slack in product and labor markets is likely to continue to exert downward pressure on the price level for some time. The key indicator to watch will be core consumer prices. If it continues to slide even as the headline CPI gyrates back and forth, then disinflation to deflation becomes a greater risk in 2010. Beyond that, if Fed policymakers fail to mop up liquidity in a timely fashion or if legislators in Washington fail to take action to reduce ballooning budget deficits, then we can begin to take the concerns of the inflation hawks more seriously.

1. Thomas Laubach. New Evidence on the Interest Rate Effects of Budget Deficits and Debt. Board of Governors of the Federal Reserve System. May 2003.