

FROM THE ECONOMICS TEAM: THOUGHTS ON JANUARY'S FOMC MEETING

Federal Reserve policymakers boosted transparency on Wednesday afternoon by introducing more specific longer-term goals for inflation, unemployment, and the level and path of the federal funds rate. But did policymakers provide greater clarity for the marketplace? We doubt it.

Two key issues stood out from the rest.

First, the FOMC confirmed an implied, "longer term inflation goal" (read: flexible inflation target) of 1.7% to 2.0% on the headline personal consumption expenditures (PCE) measure of inflation. Currently, this measure stands at 1.6% year-over-year through November. The critical implication: unless we see a sharp pick up in this measure of inflation (which we do not expect to see), the Fed has set the table for additional easing.

Second, the Fed released a series of projections on the first increase in the federal funds rate (See Chart attached) and the hypothetical path of the overnight rate out to 2016. During his press conference, Mr. Bernanke also emphasized that these forecasts, "should not be viewed as unconditional pledges". This remark, however, should be duly noted.

Many market participants appear to take these forecasts as a guarantee of "easy money from the Fed" until 2014 or beyond. Not necessarily. In fact, Mr. Bernanke explicitly cautioned that, "our [the Fed's] ability to forecast 3 and 4 years out is obviously very limited."

Here is our concern: do you really want to see how your steak is prepared, from the farm to your table? The details are messy. What's more, do you benefit if the restaurant stuffs the menu with pages and pages of entre

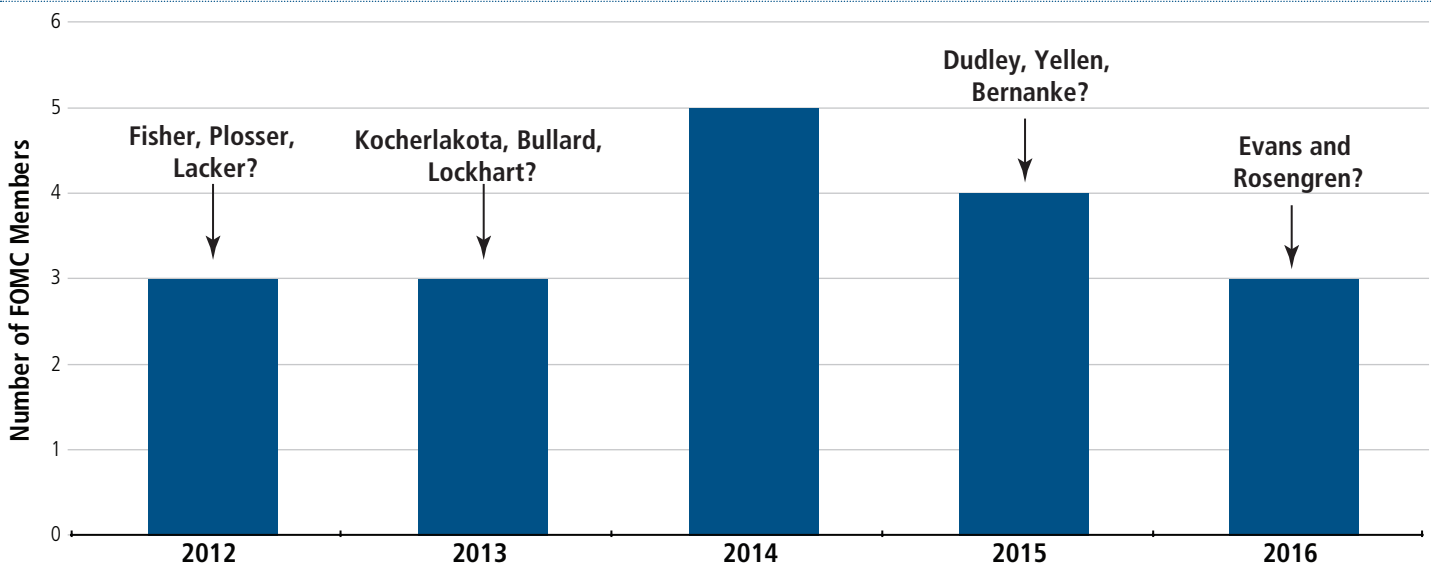
options? In the Fed's case, publishing the forecast of each FOMC member muddles things, providing more details for the market to consider without providing clarity on actual policy. With or without economic divination, Fed forecasts and ultimately Fed policy will be driven by the evolution of the data and these forecasts could be changed at least four times per year.

Further, the federal funds rate is no longer the most critical gauge of monetary policy stance. Now, the size and composition of the Fed's balance sheet impacts capital markets most. Mr. Bernanke ceded such ground during his press conference, lamenting, "we can't just lower the federal funds rate 25 basis points like in the good old days."

The expected "take off" in the federal funds rate in late 2014 does imply (from previous Fed statements) that the balance sheet asset sales would be later, somewhere around 2015 or beyond. In the meantime, the Fed will continue to hold its balance sheet near \$3 trillion (up from \$800 billion pre-crisis) and the Committee will still debate additional purchases (QE3), though Bernanke said very little on the topic.

Finally, in keeping with our "Three Themes for 2012" motif, it is worth remembering at the outset that we are in the slow process of structural (not cyclical) recovery, that our present "low interest rates" result from such a wounded macro environment, and that in such an environment we face a scarcity of "safe," liquid assets.

In short, we wonder if the Fed's increased transparency has provided greater clarity on interest rates. We doubt it.

FOMC DISPARITY ON FIRST RATE HIKE

Source: Federal Reserve