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On Yellen's Senate Testimony

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Jobs? Check! "Liftoff" hinges on inflation now. But wait, the inflation outlook is just fine.

Here's the key passage from Fed Chair Janet Yellen's prepared testimony this morning before the Senate Banking Committee. She said that when guidance changes away from the present "patient" policy stance, then "liftoff" from the zero funds rate could occur at "any meeting." What will it take at "any meeting"? Here's the money-quote:

> Provided that labor market conditions continue to improve and further improvement is expected, the Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when, on the basis of incoming data, the Committee is reasonably confident that inflation will move back over the medium term toward our 2 percent objective.

In other words, Yellen regards sufficient labor market improvement to be in the bag already, or at least a foregone conclusion. So the hinge of the "liftoff" decision will be inflation.

- This is potentially problematic, considering that by her own admission in an earlier passage, "inflation continues to run below the Committee's 2 percent objective," reflecting "In large part…the drop in oil prices."
- She goes on to cite "some pass-through of lower energy costs into core consumer prices." So it would seem that she is not being deceived by the disinflationary impact of the drop in oil prices, which is definitely an exogenous non-monetary event (see "The Deflation Hoax" January 8, 2015).
- Indeed, she concludes this analysis by saying, "The Committee expects inflation to decline further in the near term before rising gradually toward 2 percent over the medium term as the labor market improves further and the transitory effects of lower energy prices and other factors dissipate…"
- *So it would seem that the Committee has, in fact, by Yellen's own testimony, already become "reasonably confident" about the inflation outlook -- thus already satisfying the key contingency she herself cited for determining that "liftoff" is appropriate.*

Update to strategic view

US FED: In Senate testimony Yellen explicitly announced that labor market improvement is a foregone conclusion, and now the inflation outlook is the hinge of the "liftoff" decision. Yet at the same time, she seems to state that the inflation outlook, muddied by the drop in energy prices, has already met her threshold criterion for "liftoff." We have no reason to change our view that "liftoff" comes in June. Yellen is keeping her options open, and is perhaps less worried about the timing of "liftoff" as she is about the mechanics of achieving it with a large balance sheet, and against banking sector opposition to ONRPR.

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To be sure, the minutes of the January FOMC meeting released last week seemed deliberately tailored to create a dovish impression, citing "many participants" who fretted that "a premature increase in rates might damp the apparent solid recovery in real activity and labor market conditions."

Taken together with those minutes, we think Yellen is keeping all her options open. In fact, as this point, we think the FOMC might be less concerned with the exact timing of "liftoff," and more worried about the mechanics of achieving it, given its unusually large asset portfolio, and in the face of intense lobbying from the banking sector to limit the Fed's overnight reverse repo facility.

We are less concerned with the exact timing of "liftoff" than with the Fed's long-term policy stance. That, in Yellen's testimony, is completely unchanged, and it's all that really matters. She quotes verbatim the 38-word mantra we have come to call "The Yellen Rule" (see "The Yellen Rule is Taylor Minus Two" May 19, 2014), first introduced at her maiden FOMC meeting almost a year ago -- basically, a promise to keep non-zero rates abnormally lower forever. Those 38 words are below, with the essence of the policy message called out in red.

> **The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.**

Bottom line

In Senate testimony Yellen explicitly announced that labor market improvement is a foregone conclusion, and now the inflation outlook is the hinge of the "liftoff" decision. Yet at the same time, she seems to state that the inflation outlook, muddied by the drop in energy prices, has already met her threshold criterion for "liftoff." We have no reason to change our view that "liftoff" comes in June. Yellen is keeping her options open, and is perhaps less worried about the timing of "liftoff" as she is about the mechanics of achieving it with a large balance sheet, and against banking sector opposition to ONRPR.

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