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TRENDMACRO LIVE!

On the January FOMC

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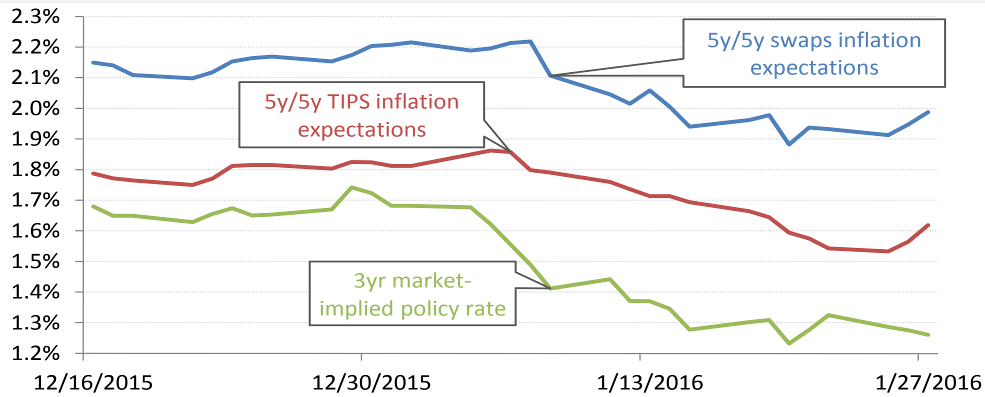
Donald Luskin

A disoriented Fed forgets to state the balance of risks. At least it dumped the Phillips Curve.

What exactly has "liftoff" lifted off? Not global stock markets. Not long-term inflation expectations. Most damningly, not even market-implied long-term policy rates (please see the chart below).

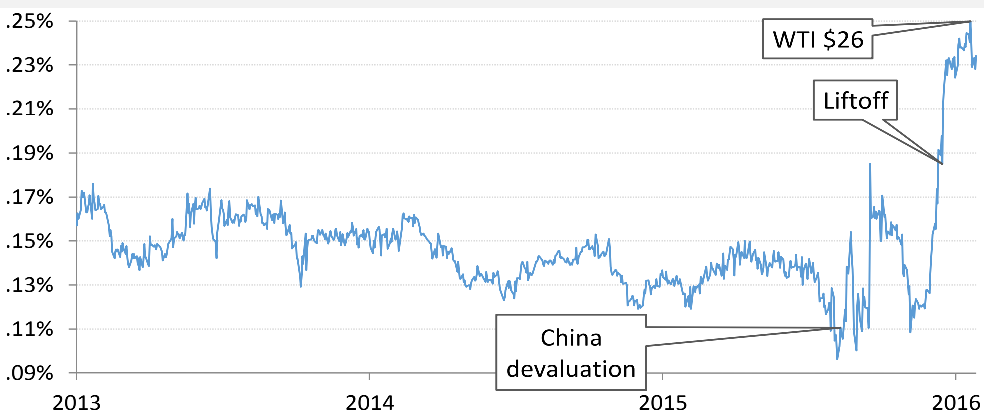
Market-implied expectations since "liftoff"



Source: Bloomberg, TrendMacro calculations

LIBOR/OIS spreads, however, *have* lifted off – implying that Fed policy has joined China's devaluation and falling oil prices in creating risks in the banking sector not seen for three years (please see the chart below).

LIBOR/OIS spread USD, 3-month



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US MACRO, US STOCKS: It's not exactly an admission of error, but it's the next best thing. The FOMC has dropped its Phillips Curve language – and admits that while job gains have been "strong," inflation expectations have "declined further." But the sudden reality that "economic growth slowed late last year" has the Fed disoriented. It removed December's assessment that risks are "balanced" – and inadvertently forgot to say whether it thinks risks are balanced now, or not! However, the FOMC has determined that "global economic and financial developments" will determine the balance, whatever it may be. The immediate negative market reaction is odd, as today's statement is constructive overall. Yes, the Fed is adrift. No, it will never admit error. But it is learning, and responding.

- *Let's face it. It was a policy error, just as we've been warning* (see, among many, "One Small Step -- In the Wrong Direction" November 23, 2015).
- More and more observers are coming around to that point of view.

The FOMC itself would never admit error. But in today's statement we see the committee struggling with the unpleasant reality of just how much the world has changed – and changed for the worse – in the six weeks since December's meeting (see "Data Insights: Federal Reserve" January 27, 2016).

The FOMC is so flummoxed by what has happened that – probably inadvertently – today's statement removes the last meeting's appraisal of the balance of risks, without offering a new one!

- December's statement said, "Overall, taking into account domestic and international developments, the Committee sees the risks to the outlook for both economic activity and the labor market as balanced." That sentence was completely cut from today's statement.
- Today, international turmoil gets more prominence – it is offered as the determinant of the balance of risks. "The Committee is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook."
- *In other words, we know what will determine the balance of risks in the future, but we have no idea what the balance of risks is now!*

No wonder the Fed is confused.

- *The FOMC admitted that "economic growth slowed late last year," when just six weeks ago – when it actually was "late last year" – it was saying "economic activity has been expanding at a moderate pace."*
- The FOMC said today that "Household spending and business fixed investment have been increasing at moderate rates in recent months" – at the last meeting they were called "solid." But even "moderate" is an optimistic fantasy. Both retail sales and orders for non-defense capital goods (ex-aircraft) outright declined in their most recent reports.
- With today's statement, a new worry is added: "inventory investment slowed."

It's not quite a confession of error – more like a cover-up, really – but we note with delight that today's statement excised December's pitiable genuflection before the Phillips Curve, for which we and others have been criticizing Chair Janet Yellen so bitterly (see, among many, "On the December FOMC" December 16, 2015).

- This sentence from the last meeting – "The Committee judges that there has been considerable improvement in labor market conditions this year, and it is reasonably confident that inflation will

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rise, over the medium term, to its 2 percent objective." – has been stuffed down the memory hole. _**Good riddance.**_

- What has shaken that "reasonably confident" stance of six weeks ago? The impossible has happened – impossible to a Phillips Curve devotee, at least.
- Today's statement upgraded "ongoing job gains" to "strong job gains." Yet at the same time, "Market-based measures of inflation compensation" – which last time were already said to "remain low" – now "declined further."
- In the logic of the Phillips Curve, that's just not supposed to be possible.

We're really not sure why the immediate equity market reaction has been so negative. It couldn't possibly be that market participants actually see the Fed's more realistic view of economic conditions as revelatory of weakness that was unknown until this afternoon. And it couldn't possibly be that this implicit admission of fallibility really bursts anyone's balloon – did anyone think central banks, especially this one, are infallible?

This FOMC meeting is very constructive. While the Fed may have erred, it is at least listening to feedback from the economy and the markets. Yes, today's statement reveals the Fed as a bit stunned, and more than a bit adrift. But it also made it abundantly clear that the Fed has been smacked by reality, and is appropriately questioning the shibboleths that led to December's "liftoff" error. It wouldn't surprise us one bit to see this afternoon's post-FOMC decline in equities reversed tomorrow.

Bottom line

It's not exactly an admission of error, but it's the next best thing. The FOMC has dropped its Phillips Curve language – and admits that while job gains have been "strong," inflation expectations have "declined further." But the sudden reality that "economic growth slowed late last year" has the Fed disoriented. It removed December's assessment that risks are "balanced" – and inadvertently forgot to say whether it thinks risks are balanced now, or not! However, the FOMC has determined that "global economic and financial developments" will determine the balance, whatever it may be. The immediate negative market reaction is odd, as today's statement is constructive overall. Yes, the Fed is adrift. No, it will never admit error. But it is learning, and responding.