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FED SHADOW

March FOMC Preview

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The "extended period" language will stay -- there's just no reason to drop it.

Despite all the market chatter about the Fed preparing to use its new balance sheet tools to tighten policy, and the idea that the "extended period" language is "in play" at tomorrow's FOMC meeting, we don't expect any policy changes at all. It seems very simple to us: from the Fed's standpoint, there's no reason for change and plenty of reason for no change.

Let's go back to basics. Remember the Fed's statutory mandate under Section 2(a) of the Federal Reserve Act: "maximum employment" and "stable prices."

For "maximum employment," if anything the Fed should be easing policy, not tightening it or signaling imminent tightening. With the funds rate now in an "extended period" at zero, the unemployment rate is nearly twice what it was during the "considerable period" of a 1% funds rate in 2003 and 2004 (please see the chart below). Then, unemployment had begun to

Update to strategic view

FED FUNDS: The FOMC will not remove the "extended period" language at tomorrow's meeting. Low reported inflation leaves the Fed with no side-constraint to prevent an all-out attack on the high and sticky unemployment rate.

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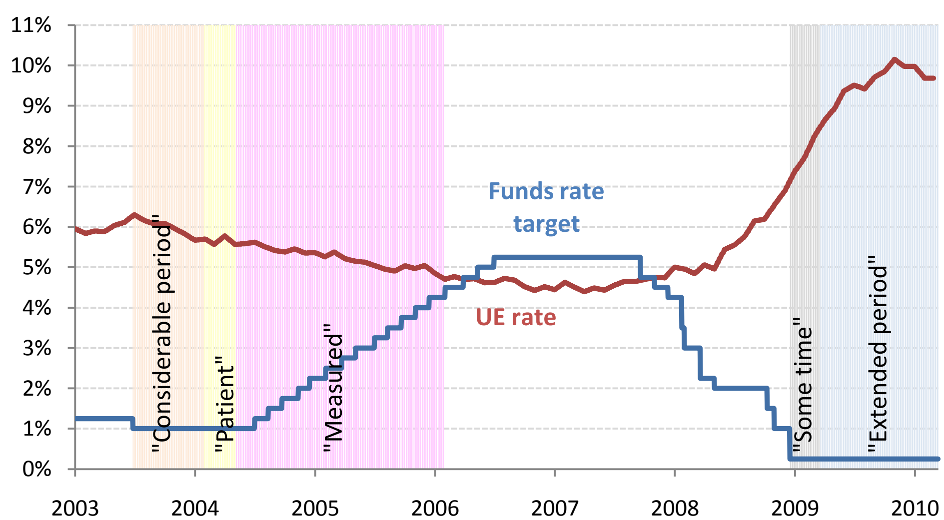
Evolving FOMC code-words and policy against the labor market backdrop

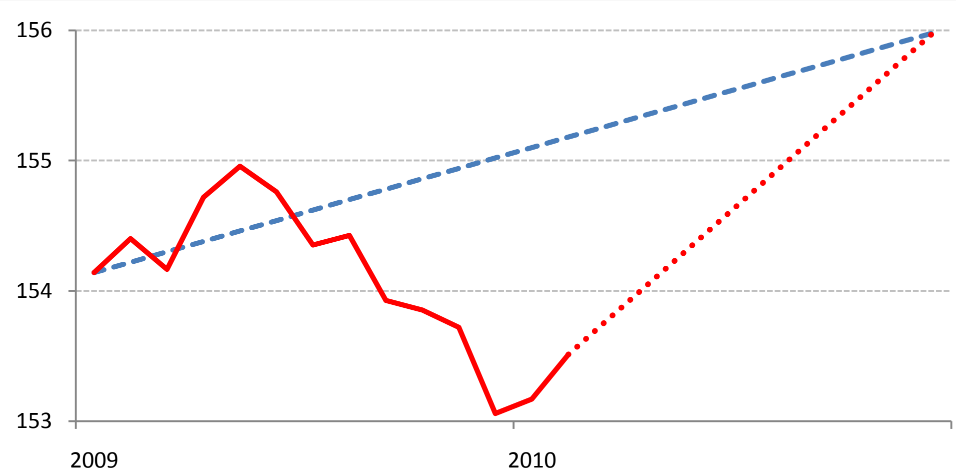


Source: Federal Reserve Board, NY Fed, Bureau of Labor Statistics fall the moment the Fed moved the funds rate to 1%, and the "considerable period" didn't end until it had established a six-month downward trend, with the unemployment rate falling by 10% of its peak value. This time, unemployment soared *after* the Fed lowered the funds rate to zero. While off the peak of last October, the drop in the unemployment rate so far has only been 5%. It would have to fall another 35% from here, or 3.39 percentage points, just to match 2003's peak level. If the unemployment rate is still that far from a level that justified a 1% funds rate, why is there any serious doubt about the longevity of a zero funds rate?

It's not as though the labor market is sizzling. It is *stabilizing and probably just about to start growing*. But even if we grant that there will be positive employment growth for the rest of the year, that doesn't mean the unemployment rate will fall. We may be in for a very strange year in which employment rises month by month, but at the same time the unemployment rate doesn't budge at all, or even moves higher. How can that be?

- To reduce the unemployment rate, job growth has to *more than* keep pace with increases in the size of the labor force.
- This will be a challenge, because the labor force naturally grows at about 80,000 persons each month do the immigration and aging.
- Additionally, in the seven months since the labor force's peak last May to its trough in December, it shrank by 1.89 million persons, rather than growing by 560,000 as demographics would dictate -- combining to a 2.46 million gap.
- So going forward as the economy recovers, in addition to 80,000 persons entering the workforce each month from demographics, 2.46 million persons who either exited or failed to enter over the last year will now re-enter. Assuming their re-entry is spread out evenly over a single year, then the labor force will grow by 285,000 each month (please see the chart below).

The labor force, millions: - - Potential — Actual - - Re-entry



Source: Bureau of Labor Statistics, TrendMacro calculations

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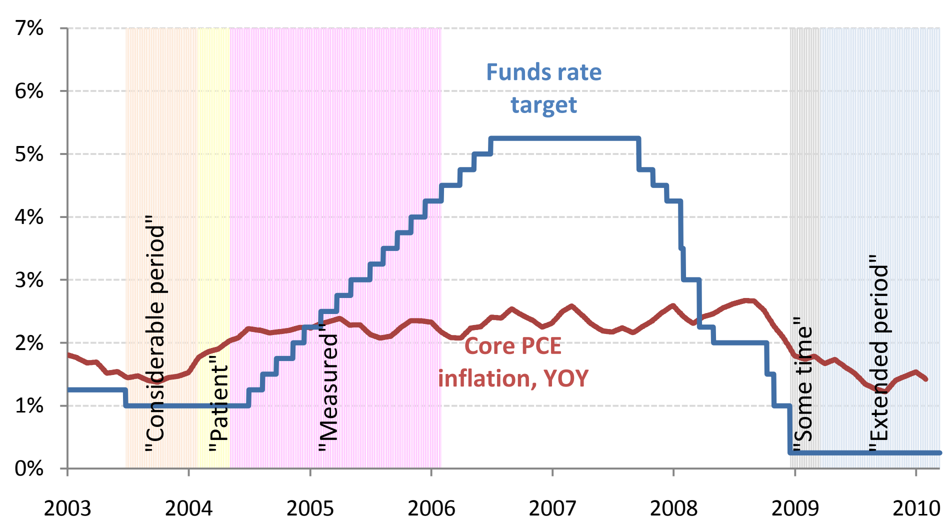
- With the unemployment rate a 9.7%, unless all but 9.7% of those 285,000 entrants get jobs -- that is, 265,000 net jobs -- then the unemployment rate will rise even as the number of employed persons rises, too.
- It's already started to happen (see "On the February Jobs Report" March 5, 2010). Last month the unemployment rate rose slightly (it was reported as unchanged, but it actually rose when carried out to full decimal precision). This happened despite 308,000 net new jobs, according to the Bureau of Labor Statistics' Household Survey. The unemployment rate nevertheless rose because the labor force increased by 342,000.
- *Voila!* Rising employment and a rising unemployment rate at the same time.

From the Fed's point of view, rising employment is a welcome development, to be sure. It means more hours worked, more aggregate income, and all the rest. But the Fed thinks in the glass-half-empty "output gap" framework. No matter how many persons are working, as long as there is a large number *not* working there is "slack" or "overcapacity" in the economy. In the Fed's view, easy policy can cause that slack to be taken up, and at the same time, the presence of that slack itself will act to keep inflation pressures in check.

Which brings us back to the Fed's mandate, the second part of which is "stable prices." Right now, looking at virtually any standard inflation statistics, achieving stable prices is simply not a worry for the Fed. So it can keep policy ultra-easy in order to address the "maximum employment" mandate without worrying about inflation as a side-constraint.

Again, it is useful to compare the present "extended period" of low rates to the "considerable period" in 2003 and 2004 (please see the chart below).

Evolving FOMC code-words and policy against the inflation backdrop



Source: Federal Reserve Board, NY Fed, Bureau of Labor Statistics

Then, core inflation was falling as the Fed lowered the funds rate to 1%. Indeed, part of the rationale for such a low funds rate was the fear of deflation, as Ben Bernanke had explained a year prior in his famous "helicopter drop" speech of November, 2002. Core inflation bottomed at 1.37% YOY in September 2003. It stabilized for a couple months, and then right after a sharp move higher, the "considerable period" language was dropped by the FOMC, replaced for two meetings by a promise that policy would be "patient." Core inflation continued to rise until the Fed finally started a cycle of "measured" rate hikes.

This time around, core inflation continued to fall for ten months after the funds rate was set at zero, falling lower than it had in 2003 and bottoming 1.21% YOY last September. Since then it has crept slightly higher. But presently at 1.42% YOY, even after recovering from its lows, it's about where it was right at the bottom in 2003. At least statistically, there's just no reason for the Fed to fear inflation -- or for that matter, to *not* fear deflation. Indeed, the most recent reported month for core CPI showed a slight deflation (see "Real Deflation" February 23, 2010), and core PCE was only barely positive.

Many observers, ourselves included, worry that these backward-looking statistics fail to capture future inflation risks, driven by what will likely be a too-prolonged "extended period" of low rates, and the lengthy maintenance of the Fed's gigantic asset portfolio. The Fed is not incognizant of such concerns. We think that some of the highly visible demonstrations of various "exit" tools -- such as the recent small hike in the discount rate (see "On the Fed's Discount Rate Hike" February 18, 2010), operational trials of reverse repos with MBS, and the re-enlargement of the Treasury's Supplemental Financing Program (see "Some Tightening!" February 24, 2010) -- are intended to placate hawks and keep inflation expectations anchored. Along the same lines, we'll bet that Ben Bernanke welcomes the hawkish rabble-rousing of Kansas City Fed President Thomas Hoenig, and his dissent at the January FOMC protesting the "extended period" language (see "Advice and Dissent" January 28, 2010). We think of all these hawkish emanations not as warning signs of impending tightening, but rather as a deliberate communications strategy designed to manipulate sentiment in order to be able to keep policy as loose as possible for as long as possible.

Bottom line

The FOMC will not remove the "extended period" language at tomorrow's meeting. Low reported inflation leaves the Fed with no side-constraint to prevent an all-out attack on the high and sticky unemployment rate.