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TRENDMACRO LIVE!

On the June FOMC

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Donald Luskin

Already dovish, now going on deflation-alert. A tiny first step toward more easing this year.

As we expected this morning (see "How to Ease, Not When to Tighten" June 23, 2010), the statement following today's FOMC meeting took an already dovish Fed further in the dovish direction. It's a small first step toward conditioning the market for further easing later in the year, unless the economy improves from here. Markets didn't react much overall, but it's telling that futures-implied year-ahead expectations for the funds rate fell after the statement from what were already all-time lows to new all-time lows -- a mere 53 bp.

- Compared to the April FOMC statement, today's presented a darker view of the economy. Improvement in the labor market is now qualified by "gradually." And "financial conditions have become less supportive of economic growth."
- Most important, the only entirely new sentence in the statement was: "Prices of energy and other commodities have declined somewhat in recent months, and underlying inflation has trended lower." Considering that inflation was already at what seemed like rock bottom, this is a coded warning of deflation.
- The paragraph containing the promise of an "extended period" of an "exceptionally low levels of the federal funds rate" was unaltered in its entirety. As we pointed out this morning, this once-controversial promise has become so institutionalized that it required no foreshadowing in inter-meeting speeches -- and the robotic repetition of the entire paragraph today shows that it's now just business as usual.

While we are extremely confident in our call for ongoing easy policy, one never really knows for sure, so we always breathe sigh of relief after every FOMC meeting. There is always the risk that the Fed will succumb to liquidationist impulses -- such as those implied in Kansas City Fed president Thomas Hoenig's persistent dissents -- in which case we think the world would quickly be plunged back into deflation and debt-destruction. With the Fed instead getting it right, we are able to reiterate our ongoing strategic theme of gradual reflation, supporting the best feasible path for our "expansionless recovery," and the continued ascent of liquidity-sensitive assets.

Update to strategic view

FED FUNDS: The "extended period" has now become so ingrained as to be an automatic fixture in FOMC statements. A coded deflation warning seals the deal that, unless the economy suddenly improves, the Fed will find ways to become even easier than it already is later this year.

US MACRO: Another FOMC meeting, another re-commitment to reflation. This keeps our "expansionless recovery" on its highest feasible path, and supports liquidity-sensitive assets.

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Bottom line

The "extended period" has now become so ingrained as to be an automatic fixture in FOMC statements. A coded deflation warning seals the deal that, unless the economy suddenly improves, the Fed will find ways to become even easier than it already is later this year. Another FOMC meeting, another re-commitment to reflation. This keeps our "expansionless recovery" on its highest feasible path, and supports liquidity-sensitive assets.