TrendMacro

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On the January FOMC

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Donald Luskin

A slight growth upgrade, a hat-tip to inflation, and no dissents -- overall dovish.

Today's FOMC statement had few changes, but more than last in last month's almost frozen text (see "On the December FOMC" December 14, 2010).

- Growth in household spending is now said to have "picked up" without qualifying it as being "at a moderate pace."
- The rate of recovery is now said to have been "insufficient to bring about a significant improvement in labor market conditions," no longer merely "insufficient to bring down unemployment."
- So on the one hand the Fed is acknowledging improving growth, but on the other it is holding growth to a higher standard -- it now must drive significant jobs growth.

There is an interesting change in tone with respect to inflation risk.

- Core inflation is now said to "have been trending downward" -- putting it in the past tense compared to last month's present tense characterization that it "continue[s] to trend downward."
- There is a new acknowledgment that "commodity prices have risen."
- It's hard to know whether this reflects a new consciousness of inflation risk -- or if it is only a sop to increasing inflation awareness in the market over the last several weeks (see "Gold Acts Leaden" January 25, 2011). Remember, the Fed actively wants inflation expectations to rise -- but not too much -- so this may be the point at which the Fed wants to both validate and limit inflation concerns by mentioning them itself.

Finally, we note that were no dissents -- even though two new FOMC voters -- Dallas's Richard Fisher and Philadelphia's Charles Plosser -- are known as strong critics of QE2.

- In combination with the raised level of inflation awareness, we take this as an especially reassuring message. Despite elevated inflation risk, the Committee is now unanimous for the first time about the continuation of QE2.

Update to strategic view

FED FUNDS, GOLD: Today's FOMC statement may have begun to lay the intellectual groundwork for the Fed standing pat at year-end and into 2012, even if the economy improves significantly as we expect. It's far from definitive, but this points to the new bull case for gold that we have been describing -- one in which the Fed unleashes what is now only latent inflation risk by becoming effectively looser simply by doing nothing.

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At the highest level, then, we think this should be seen as a "steady as she goes" message from the Fed to the markets.

- But on a deeper level, there may be clues here about how the Fed will react later this year if the economy continues to improve as much we have been forecasting (see "Stock Outlook: Differences Make a Difference" November 10, 2010). Our baseline scenario is that real GDP growth in 2011 will be in the high 3's, but that by year-end there will be not much improvement in the unemployment rate, nor much measured core inflation.
- In a world that looks like that, the Fed may be quietly hinting today that it will *still* be "steady as she goes."
- The Fed is raising the bar on jobs growth -- it now has to be "significant."
- And the Fed is limbering up its excuses if headline inflation is higher, but core is not -- as so often before, blame it on commodities.
- If this is how it plays out, it will catalyze the alternative bull case for gold we have been describing -- one based not on endless interventions to stave off systemic risk, but rather on tardy policy normalization in the face of strongly improved growth (again, see "Gold Acts Leaden").

Bottom line

Today's FOMC statement may have begun to lay the intellectual groundwork for the Fed standing pat at year-end and into 2012, even if the economy improves significantly as we expect. It's far from definitive, but this points to the new bull case for gold that we have been describing -- one in which the Fed unleashes what is now only latent inflation risk by becoming effectively looser simply by doing nothing.

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