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TRENDMACRO LIVE!

On the August FOMC

Tuesday, August 9, 2011

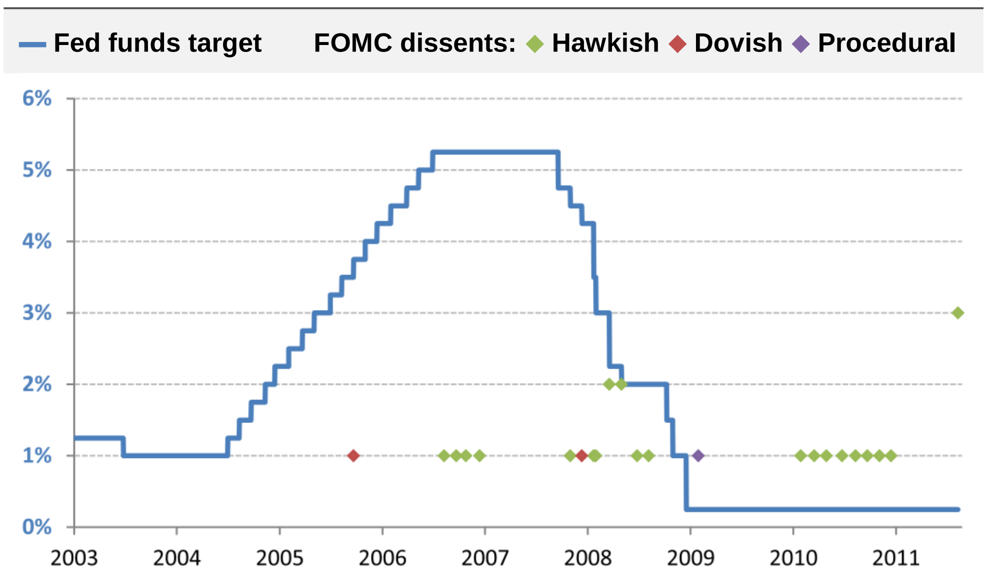
Donald Luskin

A minimalist "do something" move, with three dissents. But the Fed stands ready for more.

It's official -- in today's FOMC statement the Fed has made certain what we noted markets were expecting already (see "Downgrade: At Least the News is Out" August 8, 2011): "exceptionally low levels for the federal funds rate at least through mid-2013." The explicit setting of the minimum length of the vague "extended period" pledge is the policy move we've been recommending since last year (see "What Should the Fed Do?" August 5, 2010). In a world of heightened risk, it takes away for at least a year the risk that the Fed might raise the overnight interest rate.

Was anyone really expecting much more from the Fed? We weren't (again, see "Downgrade"). Nevertheless the immediate reaction has been strongly negative, with the day's rally in stocks entirely reversed as of this writing. But would the reaction have been any better if QE3 had been announced, as though in panic, with the Fed buying downgraded Treasury bonds exactly when everyone else is already buying downgraded Treasury bonds? How would that help at this exact moment? This was the right move.

- In a rare triple-dissent (please see the chart below) three regional



Source: Federal Reserve, TrendMacro calculations

Update to strategic view

US FED, US STOCKS, GOLD: The Fed bowed to the need to "do something" with a minimalist move tuned to reduce risk in a risk-averse market -- the risk of its own future policy course, fixing the "extended period" to at least a year. The stock market reacted badly, as though it had expected and wanted more -- but we think this will prove to only be a short-lived trading reaction. If the Fed's decision had failed to meet the true liquidity needs of this damaged market environment, then gold would have fallen -- instead, it rallied.

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Fed presidents objected to making the explicit time commitment for the funds rate -- Dallas's Richard Fisher and Philadelphia's Charles Plosser, a known hawk, and Minneapolis's Narayana Kocherlokata.

- No doubt observers will leap to the conclusion that Bernanke wanted to do more, and was held back by his committee. Perhaps it would have been difficult for him to do more, but that doesn't mean he wanted to.
- We think Bernanke is generally satisfied that the Fed's policy position is about where it should be, given unemployment and inflation (see "FOMC Preview: In Praise of Ben Bernanke" June 22, 2011). Anything more would have been more pre-emptive than we think Bernanke likes to be.
- We know that Bernanke considers pegging the "extended period" as a minimalist move. Perhaps this met the need to be seen as "doing something."
- Bernanke's position will change if conditions do -- and he is evidently concerned that they might. The statement noted that "the unemployment rate has moved up" -- when in fact it moved *down* last month -- and it forecasts inflation "at or below" the Fed's desired rate -- when in fact it rose last month on a year-on-year basis.
- Thus, as was inevitable, the statement concluded with a stand-by commitment that the Fed is "prepared to employ" a "range of policy tools available to promote a stronger economic recovery."

Bottom line

The Fed bowed to the need to "do something" with a minimalist move tuned to reduce risk in a risk-averse market -- the risk of its own future policy course, fixing the "extended period" to at least a year. The stock market reacted badly, as though it had expected and wanted more -- but we think this will prove to only be a short-lived trading reaction. If the Fed's decision had failed to meet the true liquidity needs of this damaged market environment, then gold would have fallen -- instead, it rallied.

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