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TRENDMACRO LIVE!

On the January FOMC

Wednesday, January 25, 2012

Donald Luskin

Today's real news: the Fed implicitly confesses it will not pay attention to inflation anymore.

Obviously the big news in today's FOMC statement is that the "extended period" of a near-zero fed funds rate has been extended to at least late 2014, from August's promise of mid-2013 (see "On the August FOMC" August 9, 2011).

Less obvious is that a key sentence from December's statement was *removed*: "…the Committee will continue to pay close attention to the evolution of inflation and inflation expectations." The implication is that now the Committee will *not* pay close attention.

- After a slightly more optimistically tinged posture last month (see "On the December FOMC" December 13, 2011), the mono-focus of the Fed's belief system now is its fear of "significant downside risks" to the economy. That expression was first used in the September's statement, and has now appeared in every statement since (see "On the September FOMC" September 21, 2011).
- Apparently an outright QE3 program was seen as a bridge too far at this point -- perhaps in light of the fact that it is now *de rigueur* among Republican presidential hopefuls to bash the Bernanke Fed for what is claimed to be excess money creation.
- We think such criticism of past policy decisions is wrong (see "FOMC Preview: In Praise of Ben Bernanke" June 22, 2011). That said, we see the Fed's posture now as excessively pessimistic. We continue to think that an economy working so very far below capacity could possibly have any "significant downside risks" (see, most recently, "Risk Reappraisal" January 20, 2012).
- Even without QE3, this makes the Fed's liquidity posture even more generous, at the same time as the ECB is moving along similar lines in its own way. This underscores what we said earlier this month -- this is a very positive environment for gold and other liquidity-sensitive assets (see "Cash for Gold!" January 11, 2012).

Later today the FOMC will reveal the Summary of Economic Predictions (SEP) of its members, including for the first time their expectations for the path of the future fed funds rate. We are publishing this report without waiting for that, because we assign very little importance to this new Fed communications strategy.

Update to strategic view

US FED, GOLD, US MACRO: It's not QE3. But with an extended "extended period," the Fed has set aside any concerns with inflation, and is mono-focusing on forestalling what it continues to see as "significant downside risks" to the economy." We don't see such risks to an economy working so far below capacity. Thus the Fed has begun to ease excessively, at the same time as the ECB has embarked its stealth version of QE. This bolsters the bull case for gold and other liquidity-sensitive assets.

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- *We urge that these expectations not be misunderstood as indicators of future policy.* As the FOMC feared in the minutes of the December meeting where this program was first announced,

  > …they saw an appreciable risk that the public could mistakenly interpret participants' projections of the target federal funds rate as signaling the Committee's intention to follow a specific policy path rather than as indicating members' conditional projections for the federal funds rate given their expectations regarding future economic developments. Most participants viewed these concerns as manageable…

- Members' rate expectations are part of the regular Summary of Economic Predictions (SEP), including members' outlooks for GPD, inflation and unemployment. They are simply estimates, forecasts, fears, hopes and wishes. Unless we believe that FOMC members are especially brilliant forecasters (they are not), the likely value here is to convey the mood that members are in today, at the moment when their estimates are made.
- Members' estimates of when the first rate hike might occur -- and their narrative thoughts about changes in the Fed's balance sheet -- are inextricably bound up in their expectations for background economic conditions, and therefore basically worthless. At most, their rate and balance sheet expectations might give clues as to members' preconceived ideas of what background economic conditions might give rise to policy changes.
- We believe the only reason this policy adopted was as a sop to hawkish members who have objected to the "extended period" language as excessively binding on policy, preferring instead to predicate the policy on specific future economic parameters. Richmond Fed President Jeffrey Lacker's dissent today is an example -- he "preferred to omit the description of the time period over which economic conditions are likely to warrant exceptionally low levels of the federal funds rate."
- That said, the reality is that the FOMC is a highly stratified social structure, indeed nearly an autocratic one. Decisions are made predominantly by the chairman. A tiny handful of other members are influential in the chairman's thinking. The others are just politically necessary deadweight whose ideas, including their economic forecasts, have no decision-weight. But their feelings (primarily pride) have to be managed by the chairman -- hence this new policy.
- And it's discouraging that in the name of transparency, this superfluous concession to the hawks may have the property of destabilizing markets by *creating new uncertainty* about the Fed's policy intentions -- if only because it will take time for this new modality to be correctly understood. The Fed's commitment to an "extended period" of low interest rates all the way to mid-2013 -- made in early August -- established the first low in the stock market's bottoming process, precisely because it *removed*

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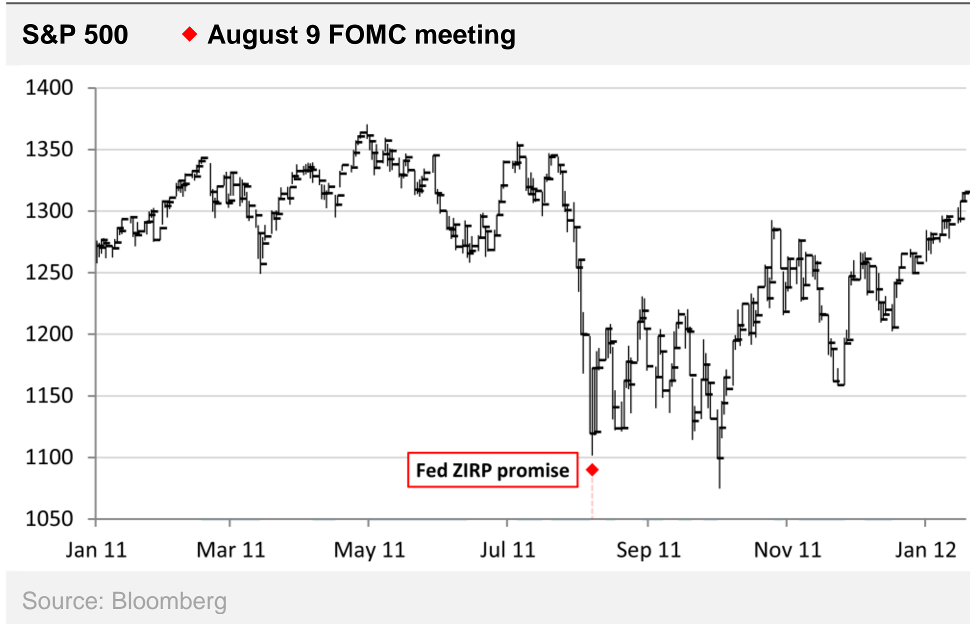
uncertainty about policy (see the chart below, and "On the August FOMC" August 9, 2011).



Bottom line

It's not QE3. But with an extended "extended period," the Fed has set aside any concerns with inflation, and is mono-focusing on forestalling what it continues to see as "significant downside risks" to the economy." We don't see such risks to an economy working so far below capacity. Thus the Fed has begun to ease excessively, at the same time as the ECB has embarked its stealth version of QE. This bolsters the bull case for gold and other liquidity-sensitive assets.