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TRENDMACRO LIVE!

On the August FOMC

Wednesday, August 1, 2012

Donald Luskin

The Fed may have just decided the election -- which may be the most it can do for growth.

We've been expecting the Fed to ease most of this year (see "On the March FOMC" March 13, 2012). We regard the last meeting's $267 billion continuation of its maturity extension program "Operation Twist," to be a disappointingly small gesture given the Fed's advanced position on the diminishing returns curve (see "On the June FOMC" June 20, 2012). So we expected further easing at today's FOMC meeting, especially in light of Chairman Ben Bernanke's assurances to Congress that the Fed "is prepared to take further action as appropriate to promote a stronger economic recovery."

- Today's failure to act makes it a virtual certainty that the Fed *will* act at the next FOMC meeting in September. Bernanke will have his Jackson Hole speech in the meantime to make it official.
- Given the long lead-times required for monetary policy to have an effect, it is possible that the Fed has missed it's last chance to influence the presidential election in November in favor of the incumbent.
- We may look back on today's FOMC as the factor at the margin that made Mitt Romney president. If clients can once again forgive what might seem on the surface to be a blatantly political view, it is our strategic call that a Romney election would benefit the economy and the markets -- by lowering the risk of the year-end fiscal cliff, and by permitting less anti-growth policy (see "It's Okay You Didn't Build That" July 20, 2012 and "The Fiscal Cliff Bites" July 12).
- This is remarkable given that Bernanke is the only important Bush appointee remaining on the Board of Governors. He is up against Obama appointee Vice Chairman Janet Yellen and liberal-leaning New York Fed President William Dudley (Vice Chair of the FOMC), both of whom we believe have been able to push Bernanke to ease three times over the past year despite his own more hawkish policy preferences (again, see, "On the March FOMC").

Politics aside, we agree with Yellen as to policy. It is evident to us that growth needs the "promotion" Bernanke promised Congress, with the Fed failing on both its inflation and growth mandates. Personal consumption expenditures inflation is running at 1.5%, and is well below trend on both a

Update to strategic view

US FED, US MACRO: No additional easing from today's FOMC meeting means the certainty of it at the September meeting. The Fed ought to have eased -- it is too tight, failing now on both its inflation and jobs mandates. The biggest effect of the decision today may be political -- given the lags in monetary policy, this may have been the FOMC's last chance to tip the presidential election in favor of Obama. If this is the marginal factor that elects Mitt Romney, then the Fed will have lowered the risk of the year-end fiscal cliff, and of anti-growth policy in 2013 and beyond.

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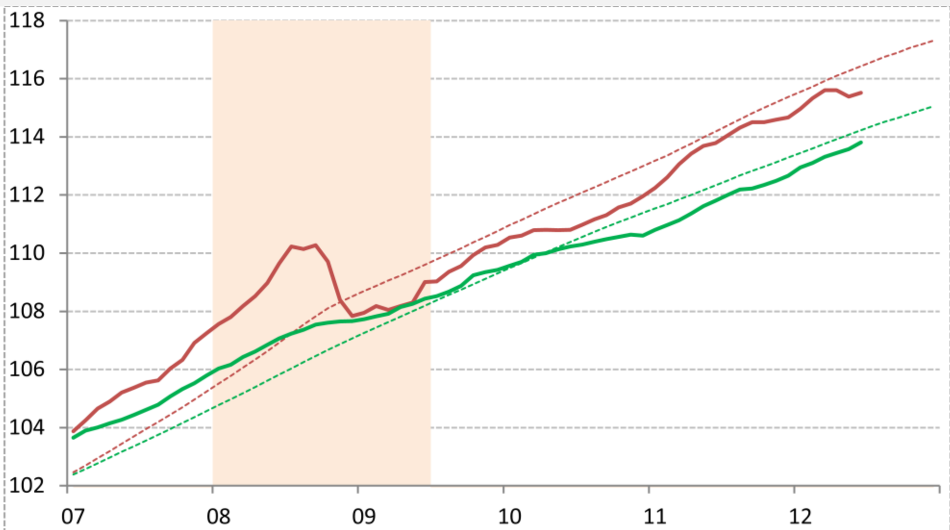
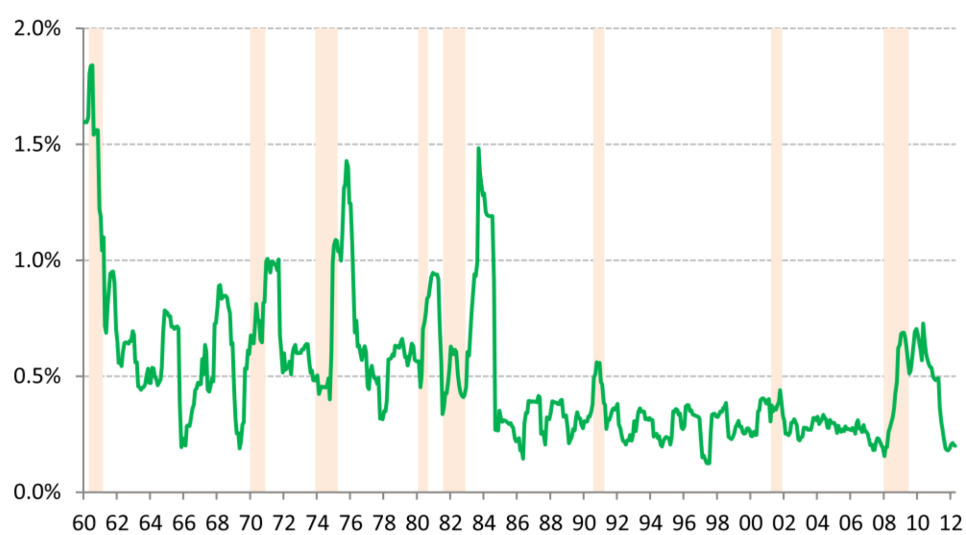
headline and core basis (please see the first chart below), and payroll jobs have settled in at an alarmingly low steady-state (see the second chart below, and "On the May Jobs Report" June 1, 2012). It is problematic how much of a difference Fed policy can actually accomplish at this point. But we are willing to accept Yellen's doctrine of "optimal control" under which the Fed is too tight (see "On FedSpeak" June 7, 2012) -- so it might as well at least solve *that* problem.

PCE price index: Headline | Core ···· | ···· 20-yr trend Recession



Source: BEA, NBER, TrendMacro calculations

Annual std. dev. of monthly change in nonfarm payrolls Recession



Source: BLS, NBER, TrendMacro calculations

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The rather sharply darkening view expressed in today's FOMC statement acknowledges as much, making it all the more tempting to speculate upon potential political intrigues in the meeting.

- In the statement from the June meeting, the FOMC said "the economy has been expanding moderately this year."
- That was already damnation with faint praise. But today's statement completely contradicted it, saying "economic activity decelerated somewhat over the first half of this year."

Among the very few changes in language from meeting to meeting, the FOMC amplified its promise to take action: "The Committee will closely monitor incoming information on economic and financial developments and will provide additional accommodation as needed." We're not forecasting any upside surprises for the Fed to closely monitor. There will be more easing in September, but that will be too late to tip the election.

Bottom line

No additional easing from today's FOMC meeting means the certainty of it at the September meeting. The Fed ought to have eased -- it is too tight, failing now on both its inflation and jobs mandates. The biggest effect of the decision today may be political -- given the lags in monetary policy, this may have been the FOMC's last chance to tip the presidential election in favor of Obama. If this is the marginal factor that elects Mitt Romney, then the Fed will have lowered the risk of the year-end fiscal cliff, and of anti-growth policy in 2013 and beyond.