TrendMacro

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TRENDMACRO LIVE!

On the December FOMC

Wednesday, December 12, 2012

Donald Luskin

So much for the Fed "targeting jobs." Turns out inflation is still a binding constraint.

The FOMC today did exactly what we expected (see "On the November Jobs Report" December 7, 2012), by replacing the expiring asset swaps under "operation twist" with outright purchases at $45 billion per month. More surprising was the abandonment of the mid-2015 pledge of ultra-low interest rates, replaced by the macroeconomic target of 6.5% unemployment subject to inflation not greater than 2.5%.

- On one level, we believe this should be seen more as a shift in *communications policy* than a shift in actual *monetary policy*.
- The mid-2015 pledge was only a contingent pledge, anyway. It had already been shifted forward in time on several occasions, as the economy failed to improve sufficiently to satisfy the Fed. And if economic factors demanded it, rates would have been hiked earlier.

But there are two important new elements here.

- First, now we know the point at which inflation becomes a binding constraint -- at 2.5%. At that level, the Fed would have to tighten even if the employment picture had not improved sufficiently. This is potentially something of a game-changer for the conventional wisdom. After QE3 was announced in September, the dominant narrative was that the Fed had put itself on a "jobs target" (see "On the September FOMC" September 13, 2012).
- In reality, inflation currently running below the Fed's target of 2% enabled extremely accommodative policy to support *both* the jobs and the price stability elements of the Fed's dual mandate.
- Today we learned that the Fed is only on a "jobs target" so long as inflation is quiescent.
- Second, the FOMC said that these triggers won't come into play until "a considerable time after the asset purchase program ends."
- So those triggers describe when the Fed will *start tightening*, not when the Fed will *stop easing*.
- Note to fiscal cliff negotiators from Ben Bernanke, who first coined the expression "fiscal cliff:" don't expect the Fed to keep taking up all net Treasury issuance. It will cease asset purchases *before*

Update to strategic view

US FED: The FOMC's new triggers of 6.5% unemployment and 2.5% inflation are of a new communications policy, not new monetary policy. The surprise is that they objectify inflation as a binding constraint on what the conventional wisdom has mistaken as the Fed's new "jobs targeting" regime. And these macroeconomic triggers only set when the Fed will start tightening. It is clear the Fed will stop easing before that. Fiscal cliff negotiators take note: there's a limit to the Fed being the buyer of all net Treasury issuance.

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unemployment reaches 6.5%, and *before* inflation reaches 2.5%. We're not wildly far from either of those levels.

Bottom line

The FOMC's new triggers of 6.5% unemployment and 2.5% inflation are of a new communications policy, not new monetary policy. The surprise is that they objectify inflation as a binding constraint on what the conventional wisdom has mistaken as the Fed's new "jobs targeting" regime. And these macroeconomic triggers only set when the Fed will *start tightening*. It is clear the Fed will *stop easing* before that. Fiscal cliff negotiators take note: there's a limit to the Fed being the buyer of all net Treasury issuance.