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TRENDMACRO LIVE!

On the July FOMC

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Funny how Yellen keeps saying "sometime this year." But the FOMC statement never does.

Fed chair Janet Yellen keeps saying that "liftoff" will come sometime this year -- she says it in speeches, in the prior FOMC's press conference, and in congressional testimony. But nothing like that has ever been said in an FOMC statement, and it wasn't said in today's FOMC statement, either. *We continue to believe that the FOMC has no actual intention of initiating the first rate hike after almost seven years at zero until it absolutely has to. And right now, and for the foreseeable future, it doesn't absolutely have to.*

Precious little in the small number of language changes from June's FOMC statement indicates any great urgency (see "Data Insights: Federal Reserve" July 29, 2015).

- The key syllable that Fed-watchers will now be discussing is the word "some" added to the forward guidance language, which we highlight in red:

  …it will be appropriate to raise the target range for the federal funds rate when it has seen ***some*** *further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective…*

- We have to conclude that this new word "some" is supposed to indicate that the degree of improvement required now is less than it used to be.
- The change in the labor market outlook is similarly minimalistic. Today's statement says "underutilization of labor resources has diminished since early this year." In June, it was "diminished somewhat."
- One syllable in, two syllables out -- all probably pointing in the direction of satisfaction with cumulative improvement in the labor market.
- Pointing in the other direction is removal of last month's observation that "energy prices appear to have stabilized." Surely the present testing of the lows of the year in global oil prices, and new lows for commodities in general, is giving the Fed pause in its optimism about inflation returning to target anytime soon.

Update to strategic view

US FED, US MACRO: Yellen keeps talking about "liftoff" sometime this year. But once again, the FOMC statement says no such thing. The fact remains that the Fed has no reason to lift off, and many reasons not too. Broad philosophical justifications for liftoff don't hold water, and the data doesn't necessitate it. So why do it, considering the unknown unknowns entailed for the global economy and for the Fed's own operations? The Fed remains "an object at rest" with liftoff indefinitely deferred, until suddenly it is not.

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Among a strong plurality of clients there is a sense that the Fed should -- and will -- lift off because "it's time," or "they need to get this started," or "they need to get it over with" -- or "it won't matter anyway, so they might as well." We sympathize with the deeper reasoning that underlies these seemingly free-floating sentiments. But we don't think they will carry the day. *Making the first-ever rate hike in a new operational world of a $4.5 trillion balance sheet, paying interest on reserves and accepting deposits from non-banks -- and with global markets still fragile to a stronger dollar -- will be a risky step into a world of unknown unknowns, and the understandably risk-averse Fed won't make that step without very concrete reasons*.

What reasons might suffice? First, let's look at the larger conceptual reasons that operate at the level of the reasons we hear voiced by clients.

- In the Q-and-A following Yellen's House testimony two weeks ago, she said:

  Well, if we wait longer, it certainly could mean that when we -- when we begin to raise rates, we might have to do so more rapidly, so an advantage to beginning a little bit earlier is we might have a more gradual path of rate increases.

- This doesn't strike us as an argument for being *early*, but rather an argument for being *not late*. Thus this is a "straw man" argument, as no one is advocating being *too late*. For all the obvious negative consequences of being *too late* -- as arguably the Fed was at the onset of the prior hiking cycle that began in June 2004 -- that says nothing about the negative consequences we face *now* by being *too early*.
- Another argument is that, as Yellen put it in the Q-and-A following Yellen's Senate testimony two weeks ago:

  …if there is a negative shock to the economy with interest rates pinned at zero, we don't have great scope to respond by loosening policy further.

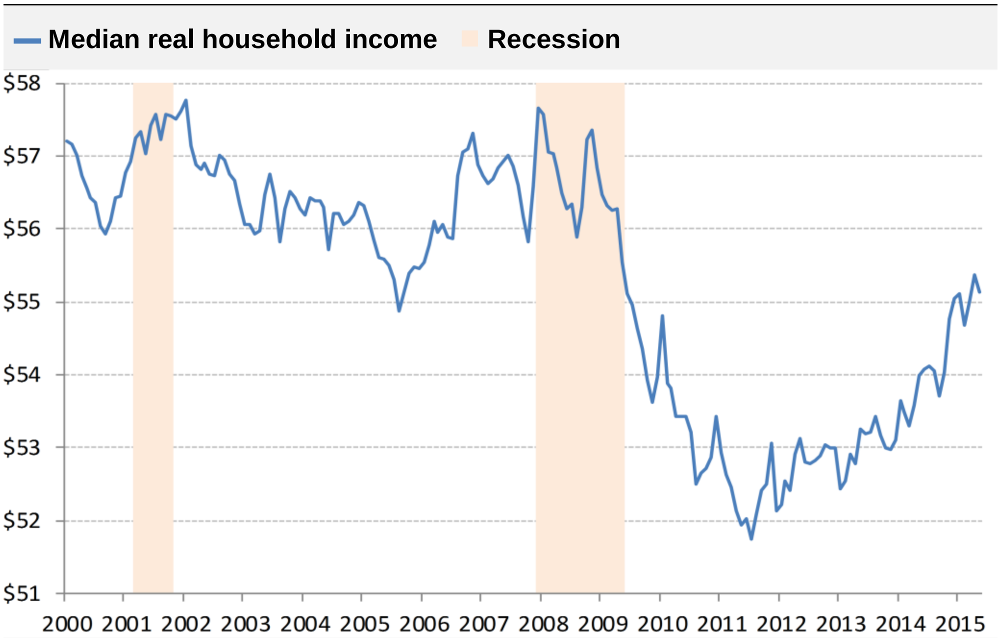
- We don't see why this is so. In almost seven years of rates pinned at zero, the Fed has been able to respond with quantitative easing and forward guidance, which it claims were quite effective.
- But more fundamentally, we don't see how it makes sense to advocate raising rates simply so that they can be subsequently lowered. Or, more pointedly, this seems to be an argument for making a policy error so that the error can be subsequently corrected. In other words, if the data does not intrinsically justify raising rates, then raising them for some other reason would be a mistake that would damage the economy, necessitating bringing rates back to where they already were before the mistake was made.

Thinking about these higher-level rationales leaves us with the conclusion that none of them makes sense without justification for a rate hike in the actual data. So let's look at the data-drivers of a possible decision to initiate liftoff.

- *Inflation won't do it. There is no visible inflation threat.*
- To be sure, with the peak in oil prices that preceded the 2014 crash about a year in the past, from here the year-over-year comparables only get less disinflationary -- especially if we are right that oil prices won't break the bottom of the $50-$65 range we have predicted for the year (see "US and OPEC: The New New World Oil Order, Volume II" July 27, 2015).
- So potentially headline CPI growth, currently at 0.10% YOY, could converge with core CPI currently at 1.8% as the next twelve months play out (see "Data Insights: CPI" July 17, 2015). But that assumes away any second-round effects as the initial shock to CPI from falling oil prices leaks into the overall consumption basket.
- And now, with commodities having fallen across a broad front, there are further disinflationary forces beyond oil (see "Another 'Reverse Oil Shock'?" Tuesday, July 28, 2015).
- Also, it should be noted that the "owner's equivalent rent" component of CPI -- the way housing prices are incorporated in the inflation calculations, which makes up the largest single component -- is quite elevated, growing now at an unusually and possibly unsustainably high rate of 3.0% YOY. Without that component, headline CPI is negative 0.5% YOY, and core is only 1.1%.
- *The labor market won't do it. There is still plenty of "slack" in the labor market.*
- The headline unemployment rate of 5.3% seems on the face of it like "full employment." And the number of short-term unemployed persons is lower than it was at the peak of the prior business cycle expansion in December 2007. But the number of long-term unemployed still has 813,000 to go. And none of that takes account of the fact that the labor force is 2.9 million persons below trend. Adjusted for the labor force participation rate at the peak of the prior business cycle expansion, headline unemployment is effectively 10.2% (see "Data Insights: Jobs" July 2, 2015).
- With all these labor market indicators telling so many complex and contradictory stories, many observers have settled on wage growth as the "sufficient statistic." It is perhaps especially attractive because it at least appears to link the labor market directly to inflation -- tying together the two sides of the Fed's dual mandate.
- But in the Q-and-A following Yellen's House testimony two weeks ago, the best thing she could say on this subject was:

  I think we're seeing at least some first tentative signs that wage growth is increasing.

- Wow -- she downgraded "signs" with no fewer than three adjectives. We'd say the signs are better than that, but still insufficient. Our favorite income indicator -- median real household income derived monthly from the BLS's Current Population Survey (please see the chart below) -- has improved to $55,132 from a low of $51,742 in August 2011.



Source: Sentier, TrendMacro calculations

- But that 2011 low was achieved more than two years after the official end of the Great Recession in June 2009, at which point median real income was $55,548. *That means for all the gains we've seen since 2011, median real household income today is still lower than it was at the very trough of the worst recession since the Great Depression.*
- With this in mind, we find it very hard to believe that the Fed would base liftoff on any notion of "wage pressure," and indeed would see that there is still a great distance to travel before any such "pressure" might arguably materialize.

We'll conclude by repeating what we always say on FOMC day. The most important revelation of the today's statement was yet another reiteration, word for word, of what we have come to call "the Yellen Rule" (see "The Yellen Rule is Taylor Minus Two" May 19, 2014) -- just as it has appeared since Yellen's first FOMC meeting over a year ago. Those familiar 38 words are below, with the essence of the policy message called out in red.

> **The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.**

So while we wait for something to trigger the necessity of liftoff, we should bear in mind that even when it comes -- even if it is *too late* -- Yellen's avowed policy is that any hiking regime will have a terminal value well below any prior regime under otherwise similar circumstances. For now the Fed remains "an object at rest" (see "On the June FOMC" June 17, 2015). When it starts to move, it will do so in the most dovish possible way.

Bottom line

Yellen keeps talking about "liftoff" sometime this year. But once again, the FOMC statement says no such thing. The fact remains that the Fed has no reason to lift off, and many reasons not too. Broad philosophical justifications for liftoff don't hold water, and the data doesn't necessitate it. So why do it, considering the unknown unknowns entailed for the global economy and for the Fed's own operations? The Fed remains "an object at rest" with liftoff indefinitely deferred, until suddenly it is not.