Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

DECEMBER 18, 2014

Patience is a Virtue, Redux

Summary: The biggest risk to our view before today's FOMC meeting was that the Fed would not worry as much about persistently low inflation as we do. After today's meeting and Janet Yellen's press conference, it's clear that, with employment and economic growth looking good, the FOMC is NOT too concerned with low inflation. As a result, if the inflation data stabilizes over the next few months, there is a greater risk that rate hikes come sooner than we had anticipated ("mid to late 2015").

Two months ago we penned a note titled, "Patience is a Virtue." In it we argued that while both job growth and economic growth were looking much better, inflation had been well below the 2% target. With that backdrop, we wrote that policymakers might adopt "Patience is a Virtue' as a mantra" in the run up to any 2015 rate-hiking decision—waiting for inflation to arrive before moving the federal funds rate.

Since we wrote that note, job growth and GDP have continued to surprise to the upside. The outlook for inflation, though, has actually worsened, in our view. In fact, data released this morning by the Labor Department showed the core Consumer Price Index (CPI) only rose 1.7% compared to a year ago. And if we exclude food, energy and shelter, inflation rose just 0.79% year-over-year through November--its lowest level since 2003. Why exclude food, energy and shelter?

Food and energy are volatile. Meanwhile, shelter is the main component pushing up the price index. In other words, if we look through the drop in energy costs and assume that shelter is a supply/demand story, not an inflation story, there is very little inflation to be worried about in the US.

We wondered this morning: how would policymakers address this low inflation conundrum? In today's FOMC statement, we received the answer. Most of the members of the Committee still expect a rate hike sometime during calendar 2015 (of course, two members do not see this happening until 2016). Policymakers still think that the low inflation we've experienced is "transitory" and, as Chair Yellen expressed in the post-meeting press conference, the Committee would be comfortable raising rates if they are "reasonably confident" inflation is headed back toward 2% and inflation expectations remained stable. In the meantime, patience would prevail. While we expect to see softer headline and core inflation data over the next few months, policymakers appear less concerned about low inflation than we had anticipated.

As a result, while the market appeared to find a dovish message in the FOMC statement, here's what we think the Fed is really saying: we aren't in any rush to raise rates, but *if* the data continues as expected over the next couple of FOMC meetings, a rate hike will probably follow.