Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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When Forecasts and Reality Collide

Wednesday featured a rare alignment of the macroeconomic stars, with key economic reports and the Federal Open Market Committee (FOMC) statement released on the same day. When the dust settled, the Fed still faced a familiar dilemma: the recent economic data have deviated somewhat from the Committee's forecasts.

Recall the relationship between economic data and monetary policy provided by Ben Bernanke after the June FOMC meeting: "If the incoming data are broadly consistent with [the FOMC's] forecast, the Committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases ["taper"] later this year." So where do we stand on GDP growth, the unemployment rate and core inflation?

First, revisions to US gross domestic product (GDP) released by the Bureau of Economic Analysis on Wednesday showed that the aggregate size US economy is 3.2% larger than previously thought, equal to about $600 billion in total output (sort of like adding an economy the size of Pennsylvania to the US). More important, though, for financial market participants and monetary policy, we learned that the economy grew at just a 1.1% annualized rate in Q1 and a slightly better 1.7% annualized rate in Q2—an average rate of just 1.4% over the first half of 2013.

But as of June the FOMC expected 2.3-2.6% real GDP growth for 2013. To reach the midpoint of that forecast range by year end the US economy needs to accelerate to 3.5% growth in both Q3 and Q4. While government spending, which subtracted 0.9 percentage point from H1 GDP growth, may cause less drag in the second half, 3.5% growth still seems unrealistic. Come the September meeting, the FOMC members should mark down their growth forecasts.

Second, July's FOMC statement acknowledged the recent disinflation trends, stating that persistent inflation readings below 2% threatened economic performance. As is the case with GDP, unless core consumer prices make a U-turn in H2 2013, inflation will still fall short of Fed forecasts (which were already revised down in June). With the average rate of core PCE inflation at 1.1% year-over-year during the first half, we would require closer 1.3-1.5% year-over-year inflation readings over the second half of the year to push inflation back into the target range of 1.2-1.3% forecast for the end of 2013. Even this would be well below the Fed's 2.0% target.

And, third, the unemployment rate. At 7.6% as of June, this is one category where the Fed's prognostications seem closest to the pin. It will take five months of 212,000 nonfarm payroll (NFP) employment growth figures and a constant labor force participation rate to reach 7.25% on the unemployment rate (the Fed's Q4 target) by December. ADP reported private payroll growth of 200,000 in July, which suggests a similar outcome on Friday's nonfarm payroll report. Nonfarm payrolls below 212,000 will make the FOMC's unemployment target less likely by year end.

What does this imply for monetary policy? Monetary policy is calibrated to the outlook. With subpar growth, high unemployment and low inflation, the fed funds rate is stuck near zero until 2015. Such a murky macroeconomic picture, and one out of accord with official forecasts, also means that QE tapering in September is no foregone conclusion. Of course, as our Mortgage Team reminds us, tapering could begin for reasons other than economic fundamentals (e.g., financial stability, mortgage market footprint concerns) and diminished downside macro risks point to less need for "QE" as an insurance policy. In the end, at the July meeting the FOMC bought itself another two months to puzzle over the effects of its large scale asset purchases, watch for the anticipated "pick up" in economic activity and decide on the appropriate calibration of monetary policy.

FED FORECASTS AND WHAT IT WILL TAKE TO GET THERE BY YEAR-END 2013

Indicator	H1 2013 Average	Fed Forecast 2013 (Central Tendency)	Average H2 Pace Required to Reach Fed Forecasts
Real GDP (%QoQ Ann.)	1.4%	2.45%	3.5%
Unemployment Rate	7.7%	7.3%	212,000 jobs/ month
Core PCE (%YoY)	1.1%	1.25%	1.3-1.5%

Source: Federal Reserve, Payden Calculations