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Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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PATIENCE...FOR NOW

The FOMC's approach is not a mystery. Monetary policy depends on how the economic data tracks the Fed's expectations.

If the economic data arrives according to policymakers' current outlook for economic growth, unemployment, and inflation (the "three pillars"), expect an interest rate hike in 2015—the first increase in the federal funds rate since 2006. And while January's FOMC meeting brought little in the way of new information, the language in the post-meeting policy statement did preserve the possibility of a June FOMC meeting "lift off" date, still two meetings away.

The first two pillars of the economic outlook look "solid"—that's the word used in the FOMC statement to characterize the US economy. With the US consumer on better footing, less of a drag from fiscal restraint, renewed housing investment and a boost to "household purchasing power" due to lower energy prices, stronger growth in 2015 seems likely. As a consequence, the unemployment rate will likely continue its gradual descent toward 5%.

It is with regards to inflation—the third pillar—that we worried the actual data wouldn't look much like the FOMC's forecast. For the past four years, the FOMC view has been that inflation will trend back towards 2%. And despite repeated failures, their forecasts predict the same for 2015 and 2016.

Our take? The Fed has been wrong year after year on their inflation predictions and policymakers risk being wrong once again. What if disinflation proves more persistent and pervasive? What if reduced labor market slack (a reasonable expectation, and part of the reason the Fed thinks inflation will return to target) has less impact on inflation than central bankers believe?

Well, this time around FOMC members have hedged themselves. In January's policy statement, policymakers said that "inflation is anticipated to decline further in the near term, but the Committee expects inflation to rise gradually toward 2 percent over the medium term as…the transitory effects of lower energy prices and other factors dissipate." Translation: we already expect prices to tumble due to lower energy prices and a more valuable US dollar in early 2015. We still think this bout of low inflation will prove to be "transitory" and that measures of inflation will move back towards the 2% target over the "medium term" (important: it doesn't have to happen this year for us to raise rates!). Therefore, lower inflation in the next few months won't be a "surprise" or a big risk to the forecast.

As a result, we think the bar to a rate hike has actually been lowered as policymakers intend to disregard the near-term dip in the inflation data. The fact that Jeffrey Lacker, President of the Richmond Fed and a notorious hawk, did not dissent in his return to voting member status on the Committee is perhaps another clue to group's collective thinking.

Perhaps more importantly for investors, even if a rate hike occurs in 2015, the glaring absence of price pressures across a wide array of measures may slow the pace of rate hikes, leaving the federal funds rate still quite low even a year or two from now.

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