Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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They Will Know "It" When They See "It"

We're befuddled. We think the key question facing policymakers heading into the much-anticipated June FOMC meeting was whether the slowdown in the US economy during the first quarter would prove transitory. We think the economic data released for the second quarter so far answered that question. Nonfarm payroll employment bounced back to +221,000 and +280,000 in April and May, respectively, wage growth picked up and retail sales suggested that the US consumer is indeed alive and well.

But the Fed is still not sure.

Despite noting the recent uptick in economic activity, Chair Janet Yellen stated during her post-meeting press conference that the Committee awaits "more decisive evidence" that the US economy is on the mend and that inflation will head toward the central bank's 2% target in the medium term. What exactly constitutes "decisive evidence"? In Yellen's words, "this is a judgment that the Committee will have to make" and "it won't depend on a single indicator." Each meeting, the Fed will assess the economic data to determine if a rate hike is warranted. In other words, they'll know it's time for a rate hike when they see it. But we aren't there yet.

As a result, the "dot plot" the Fed publishes that displays each member's assessment of future policy rates grabbed market attention. The median "dot" now shows that while the forecasted level for the fed funds rate at year end is still 0.625% (implying two 25 basis point rate hikes), five policymakers now see just one hike in calendar 2015 compared to the lone participant who felt that way at the March meeting. Further, the median "dot" reaches 1.625% by the end of 2016 (25 basis points lower than it was in March) and 2.875% the end of 2017 (down from 3.125% in March). In effect, this new version of the "dots" implies a shallower path to future interest rates than before. Financial markets reflected this "dovish" change to Fed forecasts with lower Treasury yields and higher equity prices on Wednesday afternoon.

While the market focuses on "the dots," it's the economic data that will determine what happens with interest rates. We continue to believe that many market participants and some policymakers underestimate the strength of the US economy. In our judgment, further economic gains to the tune of 2.5-3.0% annualized GDP growth, continued strong employment and wage gains and somewhat firmer inflation readings are likely over the balance of this year. We think such economic developments would be consistent with one or two rate hikes. While a first rate hike did not happen in June, the meetings scheduled for July, September, October and December all present viable options for the Fed to shake up monetary policy.

In the meantime, we will continue to scour the economic data for decisive evidence.

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