Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

JUNE 19, 2014

"IT DEPENDS."

Referring to the path of monetary policy and the timing of the first federal funds rate hike, "it depends" was the only guidance on interest rates Chair Yellen provided at her post-FOMC meeting press conference. If growth inflation and unemployment trends evolve in line with policymakers' forecasts, monetary policy will follow suit. Deviations from expectations will give policymakers reason to pause, and perhaps shift gears.

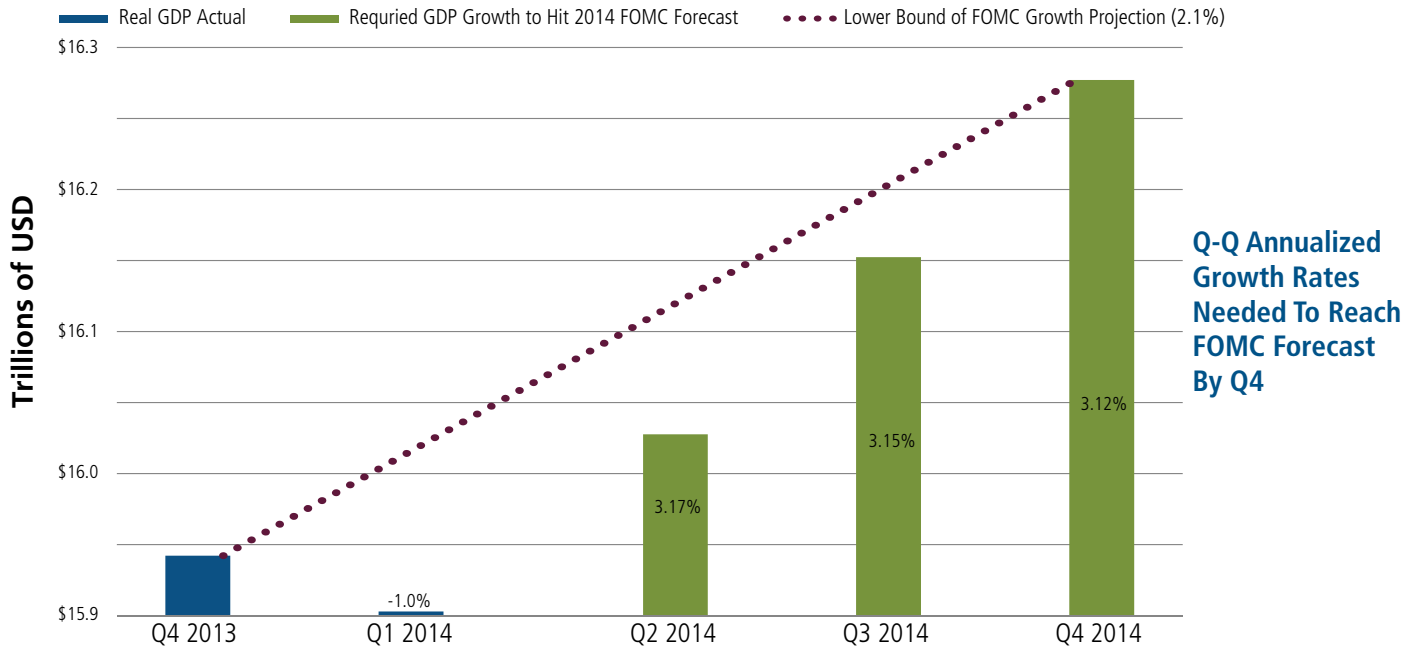
Taking into account the deep GDP contraction in Q1, the FOMC slashed their 2014 GDP growth forecast. Where formerly the Fed expected 2.9%, they now expect the US economy to register year-over-year growth at 2.2% by the Q4. Despite the drop, to achieve the full year projection, the US economy needs to grow at an average annualized rate of 3.15% in Q2, Q3 and Q4 (see updated chart attached). The US economy hasn't registered three quarters above 3% since 2004 and we don't anticipate that changing in 2014.

On inflation, the FOMC expects the core PCE measure to rise back toward 2% over time, reaching 1.6% by the end of 2014. Strong comments from Chair Yellen snuffed out concerns that recent increases in inflation made the Fed eager to raise rates. Where many market participants felt the Fed was "behind the curve," and would wait too long to raise interest rates after wage growth and inflation picked-up, we continue to think central bankers welcome moderately higher inflation, both as a sign that the economy is doing better and as an insurance cushion of sorts for more flexibility should the next slow down arrive. "Permanent deviations" from the 2% inflation target worry the Fed, whether above or below, not temporary "noise" in the inflation data.

On the unemployment rate, the FOMC reduced its projection for the unemployment rate, expecting it to reach 6.1% by year end. Importantly, the FOMC expects the unemployment rate to cross the critical 5.5% threshold sometime next year (2015), consistent with the majority of members thinking the first rate hike occurs around that time. However, built into this forecast is the assumption that as the labor market heals, some of the discouraged workers who have left the labor force will return, putting upward pressure on the unemployment rate (a larger labor force, all else equal, means a higher unemployment rate). However, if these folks do not return to the labor force, the unemployment rate could fall faster than the Fed expects. How would the FOMC react? You guessed it. "It depends."

Yellen's dovish tone wasn't limited to inflation. She squashed fears that financial stability concerns would drive shifts in Fed policy in the near-term. Whereas some market participants have opined that

STILL TOO ROSY? EVEN AFTER FORECAST DOWNGRADES IN JUNE, +3% GDP GROWTH EXPECTED



Source: U.S. Treasury Department

low volatility, narrow credit spreads and higher equity prices bring fears of frothy credit conditions of a bygone era (e.g., pre-2007), Yellen countered in the Q&A session, saying she has not seen "a broad-based increase in leverage, rapid increase in credit growth or maturity transformation."

We also looked for news on balance sheet normalization as a wild card out of the June meeting—but we were disappointed. Yellen indicated that the "mechanics of normalization" were discussed, but news will have to wait until later in the year. At this point, it makes sense to wrap up that discussion by year end, though perhaps the minutes of the meeting (to be released in three weeks' time) will have more details. Our thinking is that policymakers now lean toward the idea that rate hikes can occur BEFORE the balance sheet shrinks, which is an important kernel of information for the bond market. We'll have further thoughts on this topic in a future note.

Finally, the revised FOMC projections indicate that regardless of when overnight interest rates rise, they will journey back to only 3.75% in the longer-term. This will surely disappoint savers who long for the days of 5.25% overnight rates, but it also suggests that "fair value" on longer-term securities (which, in simplified terms, are just a collection of short-term securities and a risk premium) might be lower than many investors previously envisioned.

So there you have it: if growth, inflation and unemployment rate "evolve" according to expectations, the FOMC is on track to hike rates next year. If we are right and progress deviates somewhat from expectations, this timeline could be pushed out. But, even when rates rise, the expectation is that they rise back to levels lower than we've seen in previous cycles—and perhaps more slowly. If so, longer-term interest rates today may not be too remote from estimates of "fair value."

Then again, it depends.