Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

MARCH 19, 2014

YELLEN DOT DOT DOT

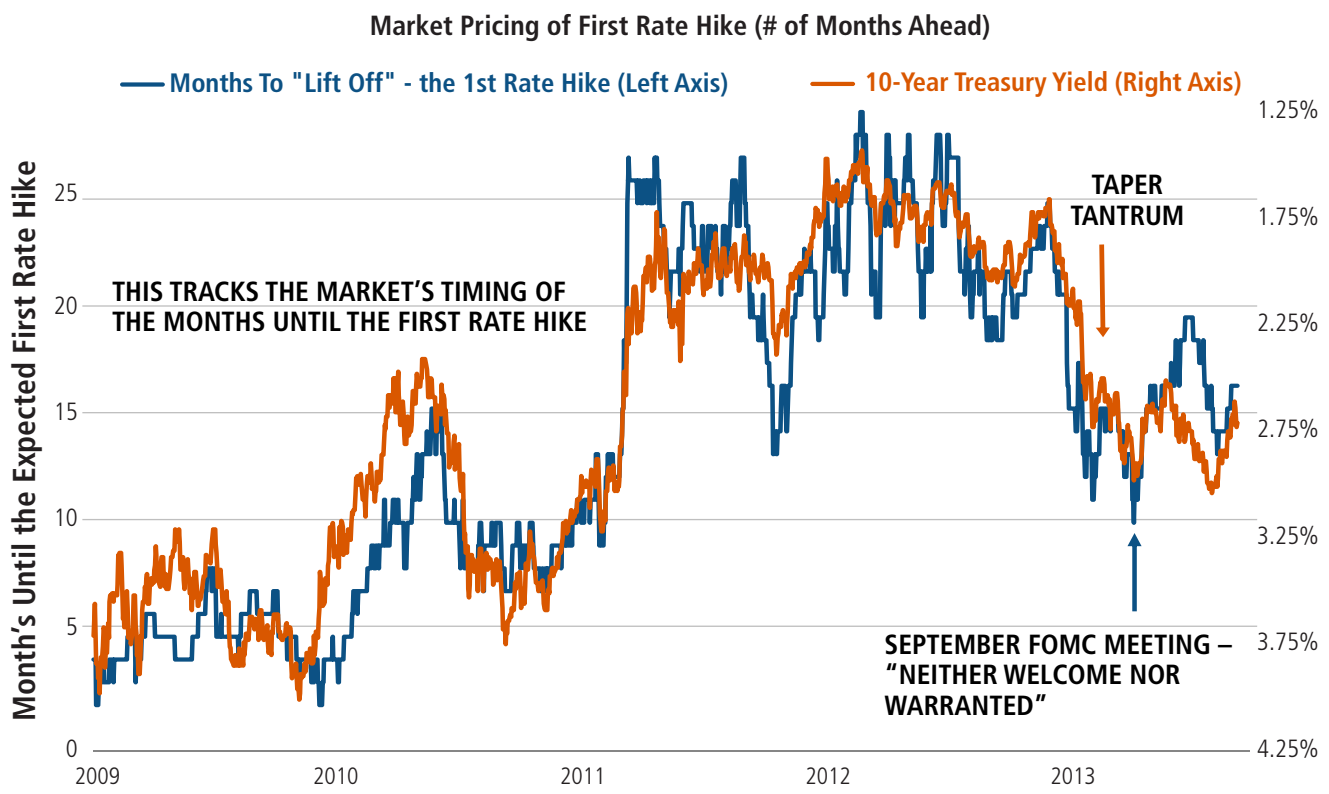
The FOMC issued a lengthy new statement and Janet Yellen answered questions for an hour—but the market heard just two words: "six months."

As widely expected at Wednesday's March FOMC meeting, the Fed further reduced the pace of its asset purchase program (QE3) to $55 billion per month beginning in April and alerted the market that short-term interest rates would likely remain low until sometime in 2015 using "qualitative guidance" (words) instead of quantitative guidance (the FOMC dropped the obsolete 6.5% unemployment threshold). Indeed, the FOMC statement itself is now a bloated 877 words long, compared to just 99 words when Chairman Greenspan unveiled the document in February 1994. Most important, today's market action reaffirmed our view that changes in market expectations of the timing of the first interest rate hike (the "lift off" date) will drive bond yields across the term-structure (See Chart below).

Much debate prior to the day's meeting centered around the FOMC's so-called "Dot Plot," a scatter plot chart of where the various FOMC members see the target fed funds rate by the end of each year through 2016 and over the longer run. The projection materials that accompany the policy statement showed once again that the majority of FOMC policy makers saw the "lift off" date in 2015. Focus and chatter emanated from the commentariat on how the FOMC had updated their dots, showing a more "hawkish" expectation for 2015 year-end fed funds at 1% compared to expectations of 0.75% in the previous set of dots (see Chart on next page). Two-year yields jumped above 0.42%, 5-year yields rose to 1.66% and 10-year Treasury yields rose to 2.77% on the information.

However, during the press conference, Janet Yellen cautioned investors of the accuracy of the dot plot, saying, "One should not look to the dot plot." Instead she emphasized that the greatest focus should be paid to the FOMC's statement. Thus, it was minor changes to forward guidance language, and a conviction that the stance of monetary policy remained unchanged that Yellen seemed to highlight. Notwithstanding her direction, the market moved considerably during the press conference. So what gave?

EXPECTATIONS FOR THE FIRST RATE HIKE IN THE US ("LIFT OFF") DRIVE LONG-TERM INTEREST RATE VOLATILITY



Source: Payden Calculations, Bloomberg
**Readings Taken From Fed Funds Futures Market*

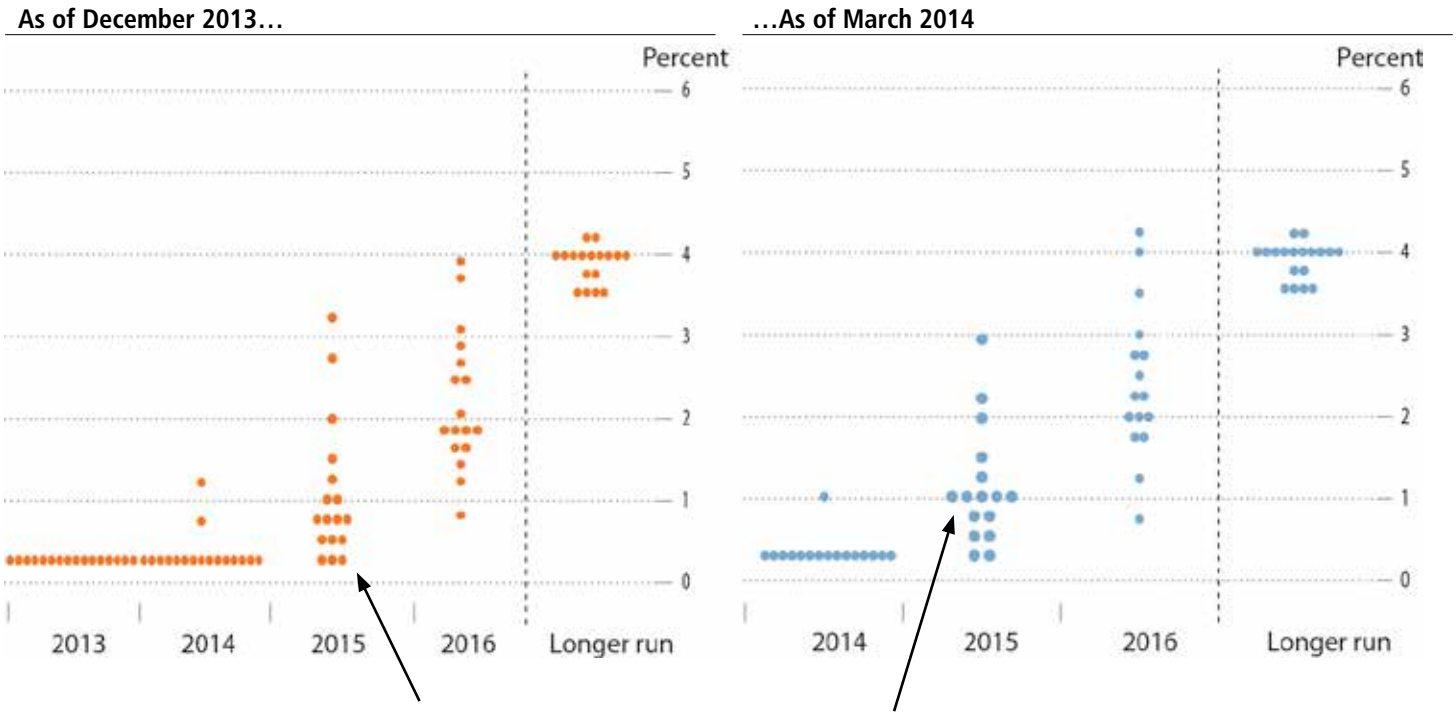
Chair Yellen telegraphed, for the first time, how long the Fed anticipates keeping rates low after ending asset purchases. Where formerly Fed officials and the policy statement stopped by simply saying that rates would remain low for a "considerable period," Yellen broke new ground by estimating such time to be "something on the order of six months."

The market reacted swiftly, calculating that an end to asset purchases "in the fall of 2014" (October 2014?) opens the door for a rate hike in the first half of 2015—slightly sooner than perhaps the market expected as evidenced by another jump in 2-year, 5-year and 10-year Treasury yields mid-press conference. We think the remark qualifies as a communications flub. Instead of being clear about the possible timing of the rate hike, Yellen injected new uncertainty over the course of three different question-and-answer volleys and roiled the market.

Before investors (and our readers) get carried away, we would caution that policy timing is calibrated to the outlook: 3% real GDP growth, 1.5% core PCE inflation, and an unemployment rate near 6.2% by year end. The FOMC has set the bar of expectations relatively high, at least in terms of GDP and PCE. If growth is slightly more sluggish (as we expect) and inflation more sticky (as we expect) then Chair Yellen & Company could shift its thinking on the timing of the first rate hike. And, finally, Yellen indicated that even when rate hikes begin, the path to higher rates would be "shallower" than previously expected.

YELLEN: "ONE SHOULD NOT LOOK TO THE DOT PLOT." THE MARKET IGNORED HER.

FOMC participant estimates of target federal funds rate at year end



Here's what the market focused on…as of December 2013 most participants expected a fed funds rate below 1%. But by March 2015, the median estimate rose to 1.0%

Source: Federal Reserve