Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

MARCH 18, 2015

So Close, Yet So Far Away

At the March Federal Open Market Committee (FOMC) meeting that concluded Wednesday, the Fed dropped the word "patient" from its post-meeting policy statement. Leading up to the event, investors worried that a lack of "patience" in the statement might send interest rates up, stocks down and the dollar into the stratosphere as the Fed edged ever nearer to the first rate hike in nearly 9 years.

Instead, on Wednesday afternoon, equity prices surged, bond yields plunged and the US dollar fell sharply in value versus the euro. So what happened?

To steal from Hall & Oates, a rate hike is so close, yet so far away.

The word "patient" had come to signal to the market that a rate hike would not occur within the next "couple of meetings," putting both policymakers and market participants at the mercy of the calendar. Removing the word from the statement opens the door to a hike as soon as the next FOMC meeting at the end of April.

But, while the Fed did away with "patient" with a few taps of the backspace button on the keyboard, it offset the word's absence with a bunch more keystrokes. In the words of the Committee in the statement, "an increase in the target range for the federal funds rate remains unlikely at the April FOMC meeting." Chair Yellen reinforced the point during her post-meeting press conference, saying a rate hike "could be warranted at any later meeting [after April] depending on how the economy evolves. It does not mean an increase will occur in June—but we cannot rule that out."

So the Fed—once again—wants you to put away your calendar and pull out your data docket. Stop asking whether it's a June or September rate hike and start asking what the data will look like in June or September. But what exactly are they looking for in the data?

Well, the Fed has been down this data-dependency road before. In fact, as Yellen remarked during the press conference, the Fed had at one point indicated that no rate hike would occur while the unemployment rate was above the 6.5% threshold.

The problem: when the Fed put forth a particular metric something else did not behave quite as expected. For example, the unemployment rate plunged through 6.5%, falling to 5.5% last month, without prompting a rate hike. What's stopping a rate hike today? What justifies a zero fed funds rate? Inflation, in particular, has not performed as policymakers had expected, remaining stubbornly low and well below target.

This time around, the FOMC says, the decision to raise the target range will depend on "further improvement in the labor market" and whether policymakers are "reasonably confident that inflation will move back toward its 2 percent objective over the medium term." When asked during the Q&A portion of the press conference to quantify what it means to be "reasonably confident," Yellen deftly demurred.

"I don't have a mechanical answer for you," Yellen replied. There's "no single thing" but rather "a wide array" and "a wide range" of indicators to consider as clues. She then proceeded to enumerate at least four of them: diminished slack in the labor market (i.e., a further fall in the unemployment rate), trends in the actual inflation data, a pick-up in wage growth (though she was careful to add that better wage growth would be a symptom of inflation not a precondition for a rate hike), and finally, stable inflation expectations.

Overall, the market's immediate reaction is revealing: either investors expected a more hawkish message out of Wednesday's affair (i.e., a calendar based signal of an imminent rate hike) or investors judged that the statement and press conference together conferred a more dovish tilt to the Fed's stance and economic outlooks. The FOMC's admission that economic growth "has moderated somewhat" and that "export growth has weakened" corroborates that view, along with marked down GDP and PCE forecasts for 2015.

But we think investors should look through the noise in some of the recent economic data and instead focus on the signal in the payroll figures. Our hunch is that the economic data will look better in the spring. We think another solid month of job growth, a further decline in the unemployment rate and hints of a pick-up in wage growth could make the Fed "reasonably confident". At the very least it would be ever harder to justify a zero fed funds rate. We will see three (3) more Employment Situation reports between today and the June FOMC meeting, providing ample opportunity for a confidence boost by summertime.

We are still so close to a rate hike and we may not be as far away as the market imagines.