Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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FOM-WILL-WAIT-AND-C

Last week's strong employment report caused consternation in the market. With the unemployment rate at 5.9% and nonfarm payroll growth consistently averaging over 200,000, would the Fed consider raising interest rates sooner? The minutes released today from the FOMC's September meeting show that, despite improvements, Fed officials will be patient in changing monetary policy. Giving them pause are a stronger dollar and low inflation. Considering each in turn, we still feel comfortable envisioning the first rate hike later rather than earlier.

First we turn to the recent performance of the US dollar. Last week alone the US dollar index rose 1.3% against a basket of major currencies. And we should not be surprised. Better US growth, especially against the weakness in Europe and Japan, combined with the prospect of Fed hikes in the near future have boosted the greenback. Good thing, right? Not for the Fed. We learned from the minutes that "some participants" thought the ongoing frailty of Europe "could lead to a further appreciation of the dollar and have adverse effects" on trade. "A couple" FOMC members also voiced worries that "the appreciation of the dollar might also tend to slow the gradual increase in inflation toward the FOMC's 2% goal." We agree. A stronger US dollar likely means more time until the first rate hike.

Much recent market chatter has been predicated on the assumption that inflation would return to 2%, as the Fed forecasted, in the next year or so. If it does not, toss any idea of rate hikes into storage for the next few quarters. As if to further highlight the troubles with a stronger dollar, the FOMC minutes took time to report that, "while most [FOMC members] viewed the risk that inflation would run persistently below 2% as having diminished . . . a couple noted the possibility that longer-term inflation expectations might be slightly lower than the Committee's 2% objective or that domestic inflation might be held down by persistent disinflation among U.S. trading partners and further appreciation of the dollar." If a "couple" members becomes the "majority" in fearing sub-2% inflation, then interest rate hikes will arrive later.

In addition to sorting out the possible fallout from a stronger dollar, the FOMC also debated modifications to their "forward guidance"—the language they use in the policy statement to give the public a good sense of how the Committee sees policy evolving. Most members feel that Fed verbiage should most nearly reflect their data dependence: that is, if inflation returns to 2% and the labor market looks healthy on a broad array of measures, the Fed will hike rates. But, on that last point, some Fed members, as we suggested last week, feel that "it would be prudent to err on the side of patience while awaiting further evidence of sustained progress . . . in their view the costs of downside shocks to the economy would be larger than those of upside shocks."

The next three business days feature eight Fed speakers. We expect to hear the word "***patience***" more than a few times.