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Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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STILL A CONSIDERABLE TIME UNTIL RATE HIKES

The Federal Open Market Committee (FOMC) announced no changes to the stance of monetary policy after its September 16-17 meeting. The Committee continued the reduction in asset purchases ("tapering") and reaffirmed its views that interest rates will remain low until unemployment and inflation more closely approximate Fed targets. All told, the message from policymakers seems to be if the current rate of economic progress continues, the first rate hike looks likely to arrive in mid-to-late 2015. But, where the federal funds rate ends up after 2015 is subject to greater uncertainty.

Of most interest to the market were slight upticks in the published FOMC forecasts for the level of the federal funds rate over the next few years (the so called "dot plot" of each policymakers' estimates). Where general agreement prevails on the appropriate level of the federal funds rate in 2014 and 2017 (the "dots" form a cluster near 0% in 2014 and 3.75% in 2017), widespread disagreement about the fed funds target prevails for 2016, with forecasts ranging from as low as 0.375% to a high of 4%! As Janet Yellen noted at the post-meeting press conference, the divergent paths for the policy rate depends on each member's base case for growth, inflation, and unemployment. Members expecting a higher federal funds rate at the end of 2016 must also expect better growth, lower unemployment and a quicker pace of consumer price inflation.

We learned today that inflation, as measured by both the headline and core consumer price index (CPI), advanced just 1.7% over the last year through August. August's lower CPI print contradicts concerns expressed by many early in the year that we were due for a jump in prices and that the Fed would find itself "behind the curve." Instead, if we exclude housing, prices rose just 0.9% over the past year, suggesting that outside of rents, the price data offer no evidence of impending inflation.

With inflation "running below the Committee's longer-run objective," what about the progress in the labor market? The FOMC marked down their year-end forecasts for the unemployment rate, now seeing a December level of 5.95%. But Yellen also confirmed that she still sees some slack left in the labor market, indicating that approximately 0.5-1 percentage points of the labor force participation rate decline occurred due to cyclical weakness rather than structural factors (e.g., demographics). Indeed, persons "out of the labor force but wanting a job now" rose to 6.4 million in August 2014 compared to 6.3 million in August 2013. Wage growth of just 2.1% year-over-year offers further indication of lingering labor market slack in the mind of the Fed Chair.

So while the US economy appears on track for a rate hike next year, considerable uncertainty surrounds where interest rates will be at the end of 2016. If inflation continues to linger below 2% and slack remains in the labor market as we expect, near zero interest rates could still be with us for some time to come.