Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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No Preset Course Redux

September's Federal Open Market Committee (FOMC) meeting brought no change to monetary policy. Despite widespread expectations of a reduction in the pace of asset purchases (with some surveys reporting 99% of respondents preparing for tapering), the FOMC's policy statement reaffirmed the commitment to alter monetary policy according to the evolution of the economic data. For now, purchases of $85 billion worth of mortgage-backed securities and US Treasury securities will continue, and thresholds for the path of short-term rates (at or near zero until the unemployment rate reaches 6.5% and so long as inflation remains below 2.5%) stand unchanged.

As long-time readers know, the Federal Reserve has been clear from the outset of QE3 that the evolution of economic data would drive monetary policy not any particular date. When queried at the post-meeting press conference about the market's apparent surprise at today's decision, Mr. Bernanke replied: "I don't recall saying I was going to do any particular thing in this meeting." In June we counseled that, "What happens next will be determined by the data relative to the Fed's baseline scenario. This seems obvious, except when you consider the daily pronouncements from forecasters that, for example, the 'Fed plans to begin taper.' As Mr. Bernanke emphasized, if the FOMC were too optimistic about expectations for growth, inflation and the unemployment rate, the story could change relative to the baseline scenario. On all three counts, we think they may be too optimistic."

Accompanying the September FOMC statement, the Fed released updated forecasts for GDP growth, inflation, the unemployment rate and interest rates. The FOMC reduced their GDP forecast for 2013 and 2014, policymakers do not see inflation returning to target until end of 2015 and, as a result, most FOMC members do not see the first fed funds rate hike until 2015. Two members even see the first rate hike occurring in 2016. While the FOMC noted lessened "downside risks to the outlook for the economy in the September FOMC statement," emphasis fell instead on their decision to "await more evidence that progress will be sustained before adjusting the pace of its purchases." Chairman Bernanke drew special attention to future fiscal debates, persistently low inflation, and declines in the labor force participation rate as threats to the durability of the recovery.

The next bookmarked dates on investors' calendars will be October 29-30, the penultimate Fed meeting for 2013. In the intervening time, only four significant data points will provide the Fed with further evidence to gauge the appropriateness of current policy: the PCE price index (due Sept. 27), the Employment Situation report for September (due on Oct. 4), the consumer price index (due October 16), and the first estimate of Q3 gross domestic product (due out Oct. 30). Notwithstanding the possibility of a dramatic "pick-up" in economic growth, jobs and inflation data, the Fed may elect to wait for further indications of sustained economic improvement before adjusting policy.

Bottom line: Economic data, not dates or market sentiment, drive the FOMC's calibration of monetary policy. Changes to policy, whether they begin in late 2013 or 2014 will ultimately accord with policymakers' best estimation of the robustness of the economy. As we remarked on August 1, "a murky macroeconomic picture, and one out of accord with official forecasts, also means that QE tapering in September is no foregone conclusion." This remains true as we head into the Fall.