ECONOMIC UPDATE

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So You're Saying You're "Data Dependent," Huh?

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"A couple of participants questioned whether some financial market participants fully appreciated that monetary policy is data dependent, and a number of participants emphasized the importance of continuing to communicate this aspect of monetary policy." - Federal Open Market Committee (FOMC) Meeting Minutes, January 2016

"Data dependence." It's the Federal Reserve's monetary policy mantra. But market participants often don't get "it." Or at least that's what the Fed seems to think, as the above quote from January's FOMC meeting minutes suggests. But do policymakers get "it"? If they did, they'd probably hike the federal funds rate this Wednesday. Here's why.

Data dependence means relying on incoming economic data to drive monetary policy decisions. It means not having a preset policy course. More specifically, data dependence means that policy is calibrated to "actual and expected" progress toward the goals of full employment and a stable rate of inflation. How are we doing compared to the Fed's expectations for 2016?

On employment, the last three months saw an average of 228,000 net, new jobs added to nonfarm payrolls. That rate of payroll growth matches the 2015 average of 229,000, a year in which the US economy created 7,500 net new jobs every day! The unemployment rate is at 4.9%. The "real" unemployment rate is now 9.7%, below its long-term average. Labor force participation is rising and the share of the working age population (ages 25-54) employed is at its highest level in 7 years. The median wage for that age cohort is also up 3.6% in the 12 months ending January. **Verdict:** the labor market is in better shape than in December and, at the current rate of job growth, the unemployment rate will fall below the Fed's 2016 expectations of 4.7% before year end.

On economic growth, GDP grew 1.9% in 2015--despite headwinds from a stronger USD and a meltdown in the oil, gas and mining sectors. In 2016, things look more promising. Tracking estimates put growth between 2-2.5% in Q1. Consumer spending rose at an annual rate of 4.0% in January. We think that along with the consumer, housing, business investment and government spending will boost output, offsetting further weakness from exports to the global economy. A major area of concern, manufacturing, show signs of bottoming out in Q1, meaning it will be less of a growth drag than last year. **Verdict:** the growth picture looks better than it did in December and the Fed only expects 2.4% GDP growth in 2016.

On inflation, we've had a few upside surprises of late after years of low and stable inflation. Core CPI rose 2.2% in January compared to a year ago and core PCE, the Fed's preferred gauge, rose 1.7%. The Fed only expected core PCE to reach 1.6% at year end, so we are way ahead of schedule. Inflation expectations, which were near historic lows, have also moved higher as oil prices have rebounded. **Verdict**: the "actual" inflation picture looks better than it did in December and inflation is not far from the Fed's target. Core inflation might end up above the Fed's target by summertime, a sight few envisioned during the recent "deflation" scare.

If you are going to set policy based off data-dependence, then, well, you can see where this is going: **this week the Fed should reaffirm its economic and unemployment rate outlook, upgrade its view on core inflation and hike again.**

At least one non-voting FOMC member appears to agree. "The big picture hasn't changed in any fundamental way," John Williams, President of the San Francisco Federal Reserve Bank, opined last week. And the big picture, as of December, was for a pickup in GDP, a decline in the unemployment rate, below target inflation, all of which would have been consistent with 4 rate hikes in 2016, according to Fed projections.

Where could we be wrong in the above assessment? Going back to the "actual and expected" path, the Fed could adjust the expected part of the equation and highlight downside risks to the outlook. Federal Reserve Board Governor Lael Brainard has said that downside risks are now more prevalent than at year-end. If this risk management view prevails, the Fed could drag its feet in March, but still set the stage for April or June, as it waits a bit longer to see if early 2016 global financial market volatility has an impact on the economic data.

But Janet Yellen and Vice Chair Stanley Fischer seem to think otherwise. Yellen remarked, "[while] global financial developments could produce a slowing in the economy, I think we want to be careful not to jump to a premature conclusion about what is in store for the U.S. economy." For his part, Fischer said even more powerfully: "We have seen similar periods of volatility in recent years--including in the second half of 2011--that have left little visible imprint on the economy."

As the quotes above demonstrate, the core contingent at the March FOMC meeting may point to a history of minimal financial market feedback and to the actual and expected progress toward their 2016 goals as reasons to stay the course. So, if you truly are data dependent...well, you know what to do next.

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