Weekly Economic Commentary

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Ch–Ch–Ch–Changes...Time to Focus on the Fed's Forecasts

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Highlights

Plenty of changes likely to the FOMC statement, but policy still on hold.

The changing composition of the FOMC's voting members will receive a great deal of media attention, but is not likely to alter policy in 2012.

Economic Calendar

Tuesday, January 24
Richmond Fed
Jan

Wednesday, January 25
FOMC Meeting

Bernanke Press Conference

Pending Home Sales
Dec

Thursday, January 26
Durable Goods
Dec

Initial Claims
wk 1/21

New Home Sales
Dec

Leading Indicators
Dec

Friday, January 27
Real GDP
Q4

GDP Price Index
Q4

U of M Consumer Sentiment
Jan

The Federal Open Market Committee (FOMC) meeting, along with Federal Reserve (Fed) Chairman Bernanke's press conference and a new economic and interest rate forecast from the Fed, is likely to compete for the market's attention with the return of Congress, the debate over the payroll tax cut extension, and another full slate of fourth quarter earnings reports this week. Economic data will also vie for attention with data due out on manufacturing, housing, leading indicators, and fourth quarter gross domestic product (GDP).

Monetary policy will take center stage this week in the United States as the FOMC (the Fed's policymaking arm) holds the first of its eight meetings this year on January 24–25. With the Fed's target interest rate near zero and Operation Twist — the Fed selling some of its holdings of shorter — term Treasuries to fund purchases of longer dated Treasuries in order to keep businesses' and consumers' borrowing costs lower for longer — well underway, the market's attention is likely to be on:

- The Fed's latest economic forecast, which will likely include, for the first time, the Fed's own forecast of the fed funds rate,
- Any changes to the FOMC statement,
- Bernanke's press conference, and
- The composition of the FOMC.

Changing the Forecast

Since the release of the most recent Fed minutes (January 3, 2012), most market participants expect the Fed to begin publishing a forecast for the path of the Fed funds rate, the rate set by the Fed to control overnight borrowing between banks, at the conclusion of this week's FOMC meeting. The Fed publishes its economic forecast four times a year (January, April, June and October/November). The forecasts currently include:

- Real GDP,
- Consumer Price Inflation (CPI),
- "Core inflation" (the Fed's preferred measure of inflation) measured by the personal consumption deflator excluding food and energy prices, and
- The unemployment rate.

The forecasts are made by the entire FOMC (seven members of the Board of Governors of the Fed, including Fed Chairman Bernanke) along with the

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presidents of each of the twelve Federal Reserve district banks (Boston, Chicago, New York, San Francisco, Dallas, etc.), not just the 12 voting members of the FOMC. The FOMC's November 2011 forecast (see nearby table) was generally more optimistic than the consensus forecast. At the time we noted that even if the economy performed in line with what the consensus expected in 2012, the Fed would probably have to act to boost the economy via additional monetary policy stimulus. Since November, the incoming economic data has been better than the consensus forecast, but generally in line with the Fed's forecast. The one notable exception being the unemployment rate, which at 8.5% in December 2011, is already below the Fed's forecast for late 2012 (8.6%). In short, we do not expect substantial upward revisions to the Fed's already optimistic forecast.

The Fed thinks (and most market participants generally agree) that by publishing a forecast for the Fed funds rate that it sets, it will help to further anchor market expectations on interest rates and keep medium- and longer-term interest rates (rates that are influenced by, but not set directly by, the Fed) lower for longer. Lower rates, in turn, would help to spur consumer spending on durable goods like autos and televisions, and on housing as well. Lower rates for longer would also likely spur more business spending on capital equipment, factory expansion and hiring. Although most market participants agree that by publishing its forecast for the Fed funds rate, the Fed is being more transparent and thereby reducing market, consumer and business uncertainty around the Fed's intended path for interest rates, there is some disagreement about the overall effect the published forecasts will have on longer-term interest rates not directly set by the Fed.

Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents (%)

	Central Tendency [1]					Range [2]				
Variable	2011	2012	2013	2014	Longer Run	2011	2012	2013	2014	Longer Run
Change in Real GDP	1.6–1.7	2.5–2.9	3.0–3.5	3.0–3.9	2.4–2.7	1.6–1.8	2.3–3.5	2.7–4.0	2.7–4.5	2.2–3.0
June Projection	2.7–2.9	3.3–3.7	3.5–4.2	N/A	2.5–2.8	2.5–3.0	2.2–4.0	3.0–4.5	N/A	2.4–3.0
Unemployment Rate	9.0–9.1	8.5–8.7	7.8–8.2	6.8–7.7	5.2–6.0	8.9–9.1	8.1–8.9	7.5–8.4	6.5–8.0	5.0–6.0
June Projection	8.6–8.9	7.8–8.2	7.0–7.5	N/A	5.2–5.6	8.4–9.1	7.5–8.7	6.5–8.3	N/A	5.0–6.0
PCE Inflation	2.7–2.9	1.4–2.0	1.5–2.0	1.5–2.0	1.7–2.0	2.5–3.3	1.4–2.8	1.4–2.5	1.5–2.4	1.5–2.0
June Projection	2.3–2.5	1.5–2.0	1.5–2.0	N/A	1.7–2.0	2.1–3.5	1.2–2.8	1.3–2.5	N/A	1.5–2.0
Core PCE Inflation [3]	1.8–1.9	1.5–2.0	1.4–1.9	1.5–2.0	N/A	1.7–2.0	1.3–2.1	1.4–2.1	1.4–2.2	N/A
June Projection	1.5–1.8	1.4–2.0	1.4–2.0	N/A	N/A	1.5–2.3	1.2–2.5	1.3–2.5	N/A	N/A

Source: Federal Reserve November 2011

Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The June projections were made in conjunction with the meeting of the Federal Open Market Committee on June 21–22, 2011.

1. The central tendency excludes the three highest and three lowest projections for each variable in each year.
2. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.
3. Longer-run projections for core PCE inflation are not collected.

Changing the Target

Turning now to the potential changes in the FOMC statement, financial market participants generally expect the Fed to upgrade both its current assessment of the economy and perhaps even elevate its outlook for growth and inflation. As noted in the section above, our view is that the Fed expected the economy to improve in 2011 and into 2012, and that it is unlikely to significantly upgrade its outlook for the economy at this week's meeting. The Fed is, however, likely to extend its promise to keep rates at "exceptionally low levels" beyond mid-2013, as was first promised in August 2011. The addition of a forecast for the Fed funds rate to the FOMC's formal forecasts may make the promise to keep rates low within the FOMC statement itself a moot point.

Some market participants anticipate that the FOMC statement may hint that the Fed is mulling the possibility of targeting an inflation rate, or even targeting nominal GDP. While this FOMC meeting is a two-day meeting, which provides participants plenty of time to discuss such matters, in our view, it is unlikely that these options would be included in the statement itself at this meeting. A more likely scenario is that the minutes of this week's FOMC meeting (due out in mid-February) will hint that either inflation targeting or GDP targeting was discussed, which would suggest that they would likely become formal components of Fed policymaking later this year.

Changing the Balance Sheet

Another item in the FOMC statement that market participants are targeting as a potential change from the prior meeting is the size of the Fed's balance sheet. Operation Twist (definition above) is set to expire in mid-2012, and in our view, it is probably too soon for the Fed to make the decision to extend the program or let it run its course. Some market participants expect the Fed to announce this week that it will begin yet another round of quantitative easing (the purchase of Treasury or mortgage-backed securities in the open market) to help keep rates lower for longer. We believe that if our forecast for the economy in 2012 (2.0% real GDP growth) is achieved, the Fed will certainty want to act to support the economy via another round of quantitative easing.

While the economic hurdle of implementing QE3 may be low, the political hurdles both within and outside the Fed remain high, which leaves only the Fed's communication policies as a viable alternative in the near term. If the Fed is forced to do a third round of quantitative easing (QE3), recent public statements from Fed officials suggest that the Fed will target the mortgage-backed securities (MBS) market in an effort to encourage the still-struggling housing sector via lower rates and improved mortgage availability.

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Fed Chairman Bernanke's press conference on January 25 will be the fourth time the Chairman has taken questions from an audience of reporters following the FOMC meeting. With the market expecting several changes to the FOMC statement and to the FOMC's forecast, the press conference will likely provide Bernanke with plenty of opportunities to clarify the Fed's message. In addition to the changes in the statement, Bernanke is also likely to get quizzed on Europe, fiscal policy, and the role of electoral politics in Fed policy among other topics.

Changing the Members

The composition of the FOMC itself will change effective with this meeting, but we do not think the change in composition makes it any more or less likely the Fed embarks on QE3 in 2012. As is the case every January, the four voting positions on the FOMC that are filled by the presidents of the regional Federal Reserve banks will change hands. This process was put in place to ensure that every region in the country, and every segment of the economy, had a voice in making monetary policy. This time around, three of the four regional Federal Reserve bank presidents rotating off the FOMC as voting members are "hawks" (Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment). Three of the four regional Federal Reserve bank presidents joining the FOMC as voting members are "doves" (Fed officials who favor the full employment side of the Fed's dual mandate).

Although this shift leaves the FOMC leaning more toward the dovish end of the policy spectrum, we will continue to watch the "center of gravity" at the Fed — Chairman Bernanke, Vice Chair Yellen and New York Fed President Dudley — for any shift in tone in Fed policy in 2012. ■

LPL Financial Research 2012 Forecasts

- GDP 2%*
- Federal Funds Rate 0%^
- Private Payrolls +200K/mo.†

Please see our *2012 Outlook* for more details on LPL Financial Research forecasts.

* Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

^ Federal Funds Rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis.

† Private Sector – the total nonfarm payroll accounts for approximately 80% of the workers who produce the entire gross domestic product of the United States. The nonfarm payroll statistic is reported monthly, on the first Friday of the month, and is used to assist government policy makers and economists determine the current state of the economy and predict future levels of economic activity. It doesn't include:

- general government employees

- private household employees

- employees of nonprofit organizations that provide assistance to individuals

- farm employees

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Consumer Price Inflations is the retail price increase as measured by a consumer price index (CPI).

The Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

A Mortgage-Backed Security (MBS) is an asset-backed security whose cash flows are backed by the principal and interest payments of a set of mortgage loans. Payments are typically made monthly over the lifetime of the underlying loans.