Weekly Economic Commentary

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Most Asked Fed Question May Go Unanswered

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Highlights

This week's Federal Open Market Committee (FOMC) forecasts will likely show stronger Gross Domestic Product (GDP) growth for 2012 and a slightly lower (better) unemployment rate forecast.

The inflation forecast is likely to be little changed.

The fate of Operation Twist is still a question.

This week marks the first anniversary of the latest round of increased transparency by the Federal Reserve (Fed) as Fed Chairman Ben Bernanke will kick off a second year of post-Federal Open Market Committee (FOMC) meeting press conferences on Wednesday, April 25. Bernanke's first post-FOMC press conference was held on April 27, 2011. Bernanke also held press conferences after the FOMC meetings that ended on June 22, 2011, November 2, 2011, and January 25, 2012. While the media is likely to put most of the focus on Bernanke's press conference and on the statement released after the FOMC meeting, market participants will likely be primarily focused on the FOMC's latest forecast of the economy and the path of interest rates and how those forecasts compare to the FOMC's judgment of "normal" or trend growth in the economy. By the end of the week, the market would like to be able to more clearly assess the odds of more monetary stimulus from the FOMC when the current round of stimulus—Operation Twist—ends at the end of June 2012. In our view, despite all the information flowing from the Fed this week, that question might go largely unanswered, leaving the timing of or the decision to implement another round of easing up to the flow of economic data and events over the next few months.

The Federal Open Market Committee (FOMC)

The Federal Open Market Committee (FOMC) is the policymaking arm of the Federal Reserve. The FOMC consists of 12 members—the seven members of the Board of Governors (which includes the Chairman Ben Bernanke) of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining 11 Reserve Bank presidents, who serve one-year terms on a rotating basis. The rotating seats are filled from the following four groups of Banks, one Bank president from each group: Boston, Philadelphia, and Richmond; Cleveland and Chicago; Atlanta, St. Louis, and Dallas; and Minneapolis, Kansas City, and San Francisco. Nonvoting Reserve Bank presidents attend the meetings of the Committee, participate in the discussions, and contribute to the Committee's assessment of the economy and policy options. The FOMC holds eight regularly scheduled meetings per year. At these meetings, the Committee reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth.

LPL Financial Research Weekly Calendar

2012	U.S. Data	Fed	Global Notables
23 Apr			■ **China's Wen Jiabo visits Europe**
24 Apr	■ Case-Shiller Home Price Index (Feb.) ■ Consumer Confidence (Apr.) ■ Richmond Fed Index (Apr.) ■ New Home Sales (Mar.)		■ Netherlands: Bond Auction ■ **Italy: Bond Auction** ■ Brazil: Inflation (Apr)
25 Apr	■ **Durable Goods Report (Mar)**	■ **FOMC Decision** ■ **FOMC Economic Projections** ■ **Bernanke Press Conference**	■ Germany: Bond Auction ■ ECB: Draghi testimony to European Parliament ■ UK: GDP (Q1)
26 Apr	■ **Initial Claims (4/21)** ■ Pending Home Sales (Mar.) ■ Kansas City Fed Mfg Index		■ New Zealand: Central bank rate decision
27 Apr	■ **GDP (Q1)** ■ GDP Price Index (Q1) ■ Employment Cost Index (Q1) ■ Consumer Sentiment (Apr)		■ **Japan: Bank of Japan meets to consider additional stimulus** ■ **Italy: Bond Auction** ■ Mexico: Central Bank rate decision

Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

Doves: Fed officials who favor the full employment side of the Fed's dual mandate

Fed Issues

The issues at hand for Chairman Bernanke at the conclusion of the meeting include deciding on the fate of Operation Twist, or as it is officially called the Maturity Extension Program, which ends on June 30, 2012. Operation Twist was hinted at by Bernanke in August 2011 and was implemented following the September 21, 2011 FOMC meeting. Its goal was to keep long-term rates, used by financial institutions to set rates for consumer and business borrowers, lower than they would have otherwise been by selling some of the Fed's existing holdings of shorter dated Treasury holdings and buying longer dated Treasuries in the open market. While some market participants continue to debate the effectiveness of Operation Twist, the market's real concern is likely to be what happens next.

What the FOMC decides to do once Operation Twist ends, if anything, will largely be determined by how economic (Gross Domestic Product [GDP] growth and the unemployment rate) data along with inflation excluding food and energy prices (core inflation) behave in absolute terms, and also relative to the FOMC's projections for these metrics. As part of the increased transparency, the FOMC began publishing its forecast four times a year following each of the two-day FOMC meetings, in April 2011. Prior to that, the FOMC published its projections for key economic variables, but with a lag, including the forecasts in the minutes of the FOMC meeting, which are released three weeks after the conclusion of the meetings.

Fed Forecasts

The forecasts released by the FOMC this week will likely show slightly stronger GDP growth for 2012 than the forecast made at the January 2012 FOMC meeting, and a slightly lower (better) unemployment rate forecast. The inflation forecast is likely to be little changed.

The forecasts made at the January 24–25, 2012 FOMC meeting saw a slightly lower path for GDP growth in 2012 and 2013 (versus the forecast made in November 2011), but also a slightly lower (better) unemployment rate forecast than was made in November 2011. The FOMC's projections for inflation in 2012 and 2013 were little changed between the November 2011 forecast and the January 2012 forecast (Table 1).

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These forecasts are best viewed in comparison to the FOMC's projections of the "long run" forecast for each of the variables (Table 1). The forecast for real GDP growth over the long run (a good proxy for where the FOMC thinks

1 Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents (%), January 2012

	Central Tendency [1]				Range [2]			
Variable	2012	2013	2014	Longer Run	2012	2013	2014	Longer Run
Change in Real GDP	2.2–2.7	2.8–3.2	3.3–4.0	2.3–2.6	2.1–3.0	2.4–3.8	2.8–4.3	2.2–3.0
November Projection	2.5–2.9	3.0–3.5	3.0–3.9	2.4–2.7	2.3–3.5	2.7–4.0	2.7–4.5	2.2–3.0
Unemployment Rate	8.2–8.5	7.4–8.1	6.7–7.6	5.2–6.0	7.8–8.6	7.0–8.2	6.3–7.7	5.0–6.0
November Projection	8.5–8.7	7.8–8.2	6.8–7.7	5.2–6.0	8.1–8.9	7.5–8.4	6.5–8.0	5.0–6.0
PCE Inflation	1.4–1.8	1.4–2.0	1.6–2.0	2.0	1.3–2.5	1.4–2.3	1.5–2.1	2.0
November Projection	1.4–2.0	1.5–2.0	1.5–2.0	1.7–2.0	1.4–2.8	1.4–2.5	1.5–2.4	1.5–2.0
Core PCE Inflation [3]	1.5–1.8	1.5–2.0	1.6–2.0	N/A	1.3–2.0	1.4–2.0	1.4–2.0	N/A
November Projection	1.5–2.0	1.4–1.9	1.5–2.0	N/A	1.3–2.1	1.4–2.1	1.4–2.2	N/A

Source: Federal Reserve's Federal Open Market Committee 01/25/12

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 November projections were made in conjunction with the meeting of the Federal Open Market Committee on November 1–2, 2011.

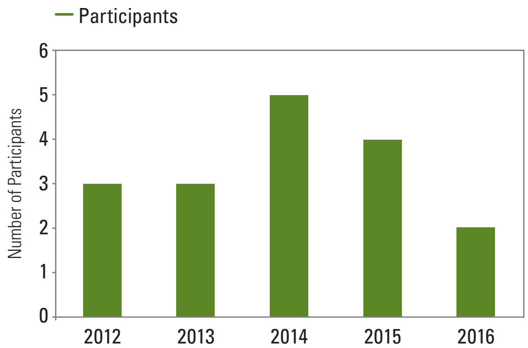
1. The central tendency excludes the three highest and three lowest projections for each variable in each year.
2. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.
3. Longer-run projections for core PCE inflation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

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.

The unemployment rate is the percentage of the total labor force that is unemployed but actively seeking employment and willing to work.

Personal Consumption Expenditures is a measure of price changes in consumer goods and services. Personal consumption expenditures consist of the actual and imputed expenditures of households; the measure includes data pertaining to durables, non-durables and services. It is essentially a measure of goods and services targeted toward individuals and consumed by individuals.

2 FOMC Participants' Assessment of First Rate Hike



Source: Federal Reserve's Federal Open Market Committee 01/25/12

the "normal rate" of economic growth is) made in January 2012 pegged GDP growth at around 2.5%, the "normal" unemployment rate at 5.6%, and overall inflation near 2.0%. Over the past few years, the FOMC's view of the long-term potential growth rate of the economy has moved down a bit, while its forecast of the "normal" unemployment rate has crept up a bit. Its forecast of what the "normal" rate of inflation is over the long term hasn't budged much.

Fed Policy Firming

Also of interest to market participants will be any shift in the FOMC's view on when the first "policy firming" (or what we used to call a rate hike) by the FOMC is likely to occur. Again in the spirit of increased transparency—which has been a hallmark of the Bernanke Fed, especially since the onset of the worst of the Great Recession and financial crisis in early 2009—the FOMC began publishing the forecasts of its own policy actions at the conclusion of the January 2012 FOMC meeting. At that meeting, well more than half (11 of 17) FOMC members expected the FOMC's first policy tightening in 2014 or later (Chart 2). Five of the 17 members of the FOMC expected the FOMC's first "policy firming" to occur in 2015, but notably, two of the FOMC's more "dovish" (those who favor the employment portion of the Fed's dual mandate to promote full employment and low and stable inflation) members didn't see any policy firming until 2016! At the other end of the spectrum, three of the more "hawkish" (members who favor the low and stable inflation side of the Fed's dual mandate) saw the FOMC first firming policy this year. This time around, we could see a few of the four '15ers join the five '14ers, given the somewhat better tone to the economic data (until the last few weeks) since the January 2012 FOMC meeting.

Putting It All Together

In short, this week's FOMC meeting, the accompanying policy statement, the Bernanke press conference, the FOMC statement, and the accompanying economic and policy projections are likely to provide plenty of fodder for financial markets in an already busy week for corporate earnings and economic data. However, the key question the market wants answered this week: Will the Fed embark on another round of quantitative easing (QE3) once Operation Twist ends, may go unanswered. ■

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.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

* 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

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.

Stock investing involves risk including loss of principal.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of United States Treasure securities).

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.

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.

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