Weekly Economic Commentary

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Fed FAQ: Fanning the FOMC Flames

John Canally, CFA
Economist
LPL Financial

Highlights

If the Fed renews Operation Twist this week, as most market participants expect, size and timing will be important.

The more specifics the Fed can provide around extending or replacing Operation Twist, the better for the markets.

The Fed continues to watch Europe closely and will likely join any global central banks' efforts to provide liquidity, if needed, to the global financial system.

Please see the LPL Financial Research Weekly Calendar on page 3

What Are the Fed's Options at This Week's FOMC Meeting?

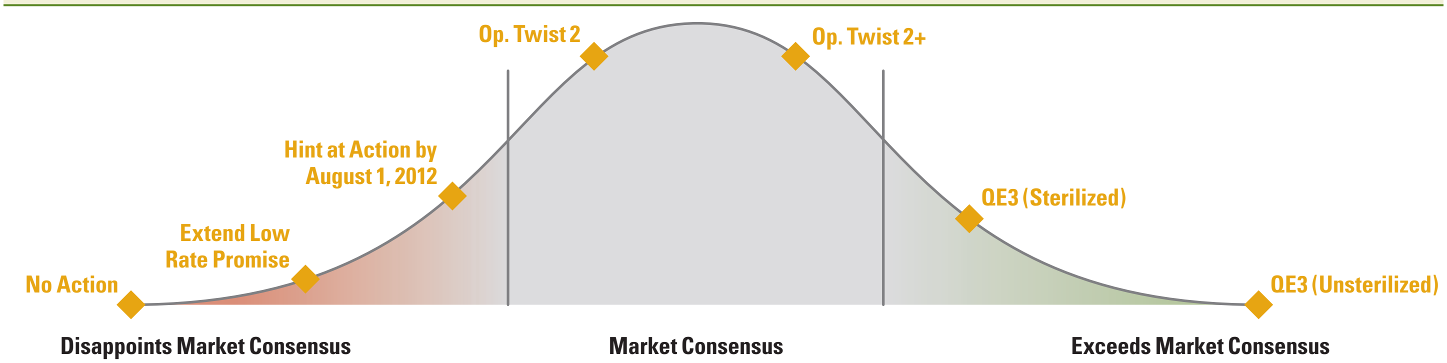
This week's meeting of the Federal Open Market Committee (FOMC) is the fourth of eight such meetings this year. Along with releasing a decision on monetary policy at 12:30 PM ET on Wednesday, June 20, the Federal Reserve's (Fed) policymaking arm will also release its latest forecast of the economy, the labor market, and inflation at 2:00 PM ET on June 20, followed shortly by a press conference with Fed Chairman Ben Bernanke.

The nearby figure outlines the most likely outcomes of the FOMC meeting. The market now expects some action from the Fed at this meeting. If the Fed does nothing—lets Operation Twist end as planned on June, 30, 2012 without replacing it with something else—markets will likely be disappointed.

Extending the commitment to keep the Fed funds rate near zero beyond the end of 2014 is the minimum the Fed could do to keep markets placated. The Fed first announced its commitment to keep rates near zero in August 2011, at the time, committing to keep rates near zero until mid-2013. In January 2012, the Fed extended its promise to keep rates at exceptionally low levels until late 2014. Still, the markets would, at least initially, view a change in the Fed's commitment to keep rates on hold as a disappointment relative to current market expectations.

If the Fed does nothing, but hints (either in the statement or via comments made by Bernanke) that further action may come as soon as the August 1, 2012 FOMC meeting, the markets would still likely be disappointed. The markets'

1 Likelihood of Market Response to Fed Outcomes



Source: LPL Financial 06/18/12

focus then would shift to Bernanke's press conference and back to the Fed's new economic forecast, as participants try to gauge the timing of the next round of stimulus.

Markets like clarity, so the more specifics the Fed can provide around extending Operation Twist, the better.

Most market participants now expect the Fed to renew Operation Twist. Twist involved the Fed selling some of its shorter-dated Treasury holdings and purchasing longer-dated Treasuries in the open market in order to keep long-term Treasury yields lower for longer. When it was first announced in September 2011, Operation Twist promised to purchase $400 billion in Treasuries by the end of June 2012. If the Fed decides to extend the program, the size and timing will be important. Will the Fed announce the size and the timing, or will it decline to pre-commit to a full dollar amount or a specified timeline? Markets like clarity, so the more specifics the Fed can provide around extending Operation Twist, the better for the markets.

An announcement that extends Operation Twist and hints that the Fed is prepared to take additional action quickly would likely be viewed more positively by markets than just extending Operation Twist beyond the end of June 2012. The more specific the Fed is in any kind of conditional promise to "do more" (extend Operation Twist, increase the size of its balance sheet, or some other kind of stimulus), the better it would be received by financial market participants. Specifics might include trigger points around inflation, economic growth, the labor market, and possibly even on the situation in Europe. In our view, however, there is a low probability that the Fed would get this specific.

Markets would likely view a third round of quantitative easing (QE3) highly favorably.

Although a few market participants expect the Fed to announce another expansion of its balance sheet, which would represent the third round of quantitative easing (QE3) by the Fed since the fall of 2008, this type of announcement would likely be viewed highly favorably by markets. The Fed could choose to purchase more Treasuries, mortgage backed securities (MBS), or both. As with extending Twist, the more specifics (on size and timing of the planned purchases), the more the markets will embrace the operation. The goal of QE3 would be to keep rates most used to set loans for consumers, homebuyers, and businesses lower for longer. In this scenario, the Fed could choose to make the purchases outright (as they did in QE1 and QE2) or sterilize the purchases. This means that the Fed would immediately borrow back some of the cash it injects into the financial system as it purchases the securities in the open market. For our analysis of what sterilized QE3 might look like, and why the Fed might choose this path, please see the *Weekly Economic Commentary* from March 12, 2012, "To QE or not to QE?"

Why Might the Fed Opt To Do Nothing This Week?

In our view, one of the key reasons the Fed might not want to pursue this course of action (i.e., another round of quantitative easing) as early as this week is politics. A third foray into balance sheet expansion so close to the elections would likely subject the Fed to intense political scrutiny from Congress (and internally as well) and may imperil the Fed's independence in the years ahead. However, if conditions became so dire that Chairman Bernanke felt it necessary to act to avoid deflation, he would likely have the votes to do so. In this case, LPL Financial Research Weekly Calendar

2012	U.S. Data	Fed	Global Notables
18 June	■ Homebuilders Sentiment (Jun) ■ **Possible Supreme Court ruling on health care reform**		■ **G-20 Summit** ■ China: Home Prices (May) ■ India: Central Bank Meeting
19 June	■ Housing Starts (Jun) ■ Building Permits (Jun) ■ JOLTS (Jun)		■ **G-20 Summit** ■ Germany: ZEW (Jun) ■ Germany: Bond auction
20 June		■ **FOMC Decision** ■ **FOMC Forecast** ■ **Bernanke Press Conference**	■ Germany: Bond auction ■ Norway: Central Bank Meeting
21 June	■ **Market PMI (Jun)** ■ Initial Claims (6/16) ■ Leading Indicators (Jun) ■ **Existing Home Sales (Jun)** ■ Philly Fed (Jun)		■ **Eurozone: Finance Ministers Meeting** ■ Brazil: Inflation data (Jun) ■ **Spain: Bank stress test results** ■ **Spain: Bond auction** ■ France: Bond auction ■ Taiwan: Central Bank Meeting
22 Jun			■ **Eurozone: Leaders' Summit** ■ Germany: IFO Index (Jun)

Job Openings and Labor Turnover Survey (JOLTS) is a survey done by the United States Bureau of Labor Statistics to help measure job vacancies. It collects data from employers including retailers, manufacturers and different offices each month. Respondents to the survey answer quantitative and qualitative questions about their businesses' employment, job openings, recruitment, hires and separations. The JOLTS data is published monthly and by region and industry.

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Bernanke and the center of gravity at the Fed would probably like to keep some "dry power" on hand in case conditions in the United States (either economically or fiscally) or abroad deteriorated.

What Else Could the Fed Do This Week?

At various times over the past several years during the Great Recession and its aftermath, the Fed has discussed several alternative measures of influencing the economy via monetary policy. These include:

- **Gross Domestic Product (GDP) targeting.** Where the Fed would target a level of economic growth and continue to pursue monetary policies until the GDP target growth rate is achieved.
- **Inflation targeting.** Similar to GDP targeting, the Fed would target a specific level of inflation (currently, the Fed's unofficial target is around 2.0%) and conduct monetary policy until the inflation rate reaches or exceeds the target rate.
- **Target duration of Fed Treasury and MBS holdings.** This is similar to Operation Twist, as the Fed would announce a specific maturity or duration target of its holdings of Treasuries or MBS and conduct purchases and sales of these securities until that maturity or duration target was achieved.

In our view, it is unlikely that the Fed will pursue alternative measures at this week's FOMC meeting, but they remain options should the Fed run out of other ways to impact the economy via monetary policy.

What Can the Fed Do About Europe?

In recent public appearances, various Fed officials have cited the financial and fiscal turmoil in Europe as possible triggers for more monetary policy easing in the United States. Indeed, slowing U.S. economic growth, slumping consumer and business confidence, and downward pressure on domestic inflation from Europe are likely nudging Fed policymakers to act on domestic policy this week.

The Fed will likely join in any efforts by global central banks to provide liquidity, if warranted, to the global financial system in the weeks and months ahead to help ensure that global financial institutions can continue to provide consumers, and small and large businesses alike, with credit.

More globally, the Fed will likely join in any efforts by global central banks to provide liquidity, if warranted, to the global financial system in the weeks and months ahead to help ensure that global financial institutions (banks, insurance companies, and other central banks, central and local governments) can continue to provide consumers, and small and large businesses alike, with credit. As recently as November 2011, the Fed was part of a coordinated effort by global central banks to expand interbank lending in dollars. Similar actions are more likely than not in the coming weeks and months, and can be achieved without the Fed expanding its balance sheet or changing domestic monetary policy in any way.

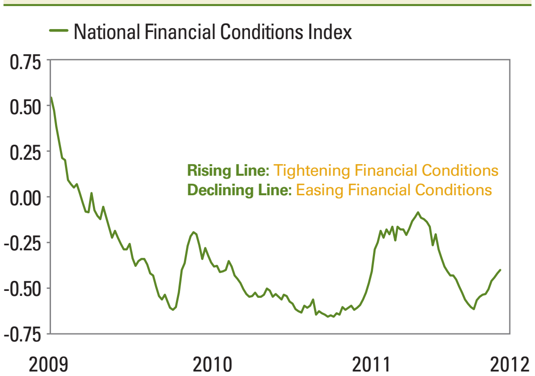
Does the Fed Change Rates in an Election Year?

For the record, the Fed has either raised or lowered (and in some cases both in the same year!) its short-term policy rate in every single presidential election year over the past 45 years. In general, the Fed wants to avoid mingling in politics during an election year, and it may prefer to hold off on adjusting policy in the months just prior to the elections in November. But when push came to shove, the Fed acted to change policy as conditions warranted and will likely do so again over the second half of this year if conditions warrant.

Fed policymakers would likely prefer to not begin a new round of quantitative easing in the weeks and months leading up to the November 6 elections, leaving the Fed only a narrow window between the scheduled end of "Operation Twist" on June 30, 2012 and the onset of the fall presidential campaigns, which traditionally swing into high gear after Labor Day.

Thus, although there is likely to be political blowback if the Fed decides to act this week, history is on the side of Fed action in this case.

2 Tighter Financial Conditions in Recent Months Are Likely Adding to the Fed's Urgency to Act



Source: LPL Financial 06/18/12

Why Would the Fed Consider Acting This Week?

As we have written in prior *Weekly Economic Commentaries,* the Fed has a dual mandate to promote low and stable prices and to foster conditions that lead to full employment. Recent data points on employment, the overall economy, and inflation suggest that:

- The labor market is softening again, with the unemployment rate at 8.2% in June 2012, and is in danger of rising further over the remainder of this year, and may not fall to the Fed's forecast of 7.9% by the fourth quarter of 2012.
- The overall economy remains near stall speed and below the Fed's forecast (2.75% for real GDP growth in 2012 and 2.9% in 2013). The economy grew at just 1.9% in the first quarter of 2012, and thus far in

the second quarter of 2012 is on track to post growth closer to 1.5% than 2.0%. Our forecast remains that the economy will grow at 2.0% in 2012.

- While deflation, a prolonged period of falling prices and wages, is not likely, and both headline and core (excluding food and energy) inflation remain above the FOMC's forecast range for 2012, headline inflation has decelerated sharply this year and core inflation has stabilized. With plenty of slack in the labor market, wage gains are nearly nonexistent. Since labor costs account for roughly two-thirds of business' costs, there is little ability to pass through price increases. In addition, inflation expectations (of consumers, businesses, and professional forecasters), a key input to the Fed's process on monetary policy, have barely budged in recent years and suggest that inflation expectations remain well contained.
- In addition, the potential for much more restrictive fiscal policy next year as tax hikes and spending cuts go into effect may prompt the Fed to provide more stimulus. Indeed, financial conditions have already worsened (including measures like interbank lending rates, yield curves, credit spreads, price-to-earnings ratios, and the value of the dollar). Although conditions have not deteriorated as much as they did prior to the start of QE2 in the fall of 2010 or summer 2011 prior to the announcement of Operation Twist, financial conditions have deteriorated rapidly since the start of April 2012 [Figure 2].

Is There Evidence the Fed Is Failing to Achieve its Dual Mandate?

In recent public appearances, Fed officials of all stripes (hawks and doves) have noted that the Fed is taking into account the lingering financial and fiscal crisis in Europe, as well as the looming fiscal cliff here in the United States. While these issues will likely be discussed at this week's FOMC meeting, the participants will want to rely primarily on how the economy is tracking towards its dual mandate in making and communicating whatever decision it makes this week.

In the Fedlines box on the following page, we cite recent speeches from two Fed officials who point out that the Fed appears to be failing in one or both of its mandates. ■

Fedlines

Yellen and Dudley Make the Case for More Policy Action From the Fed

The section below contains excerpts from a speech given by Fed Vice Chair Janet Yellen on June 6, 2012, in Boston entitled: Perspectives on Monetary Policy.

While Yellen is a well-known monetary policy "dove," her views are thought to be closely aligned with Fed Chairman Bernanke's views.

- "If the Committee were to judge that the recovery is unlikely to proceed at a satisfactory pace (for example, that the forecast entails little or no improvement in the labor market over the next few years), or that the downside risks to the outlook had become sufficiently great, or that inflation appeared to be in danger of declining notably below its 2 percent objective, I am convinced that scope remains for the FOMC to provide further policy accommodation either through its forward guidance or through additional balance-sheet actions. In taking these decisions, however, we would need to balance two considerations."
- "In particular, as I have noted, there are a number of significant downside risks to the economic outlook, and hence it may well be appropriate to insure against adverse shocks that could push the economy into territory where a self-reinforcing downward spiral of economic weakness would be difficult to arrest."

The section below is text from a speech given by President of the Federal Reserve Bank of New York, William Dudley, on May 24, 2012, in New York City.

- Dudley is also a well know monetary policy "dove." We have long viewed Dudley, along with Yellen and Bernanke, as the "center of gravity" of the Fed. His recent remarks can also provide some insight into what the Fed may do next.
- "As long as the U.S. economy continues to grow sufficiently fast to cut into the nation's unused economic resources at a meaningful pace, I think the benefits from further action are unlikely to exceed the costs. But if the economy were to slow so that we were no longer making material progress toward full employment, the downside risks to growth were to increase sharply, or if deflation risks were to climb materially, then the benefits of further accommodation would increase in my estimation and this could tilt the balance toward additional easing."

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

Doves: Those favoring the full employment side.

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.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

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.

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).

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semi-annually and the income that holders receive is only taxed at the federal level.