LPL FINANCIAL RESEARCH

Weekly Economic Commentary

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Making a Statement

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Highlights

Markets will soon be asking: When will the Fed raise rates? What measures of inflation, employment, and other economic indicators will the Fed be watching most closely? How fast will rates rise once rate hikes begin?

We expect the FOMC to revamp its overly complex statement beginning at this week's FOMC meeting.

We continue to expect the FOMC to taper quantitative easing by $10 billion at each FOMC meeting this year.

The policymaking arm of the Federal Reserve (Fed), the Federal Open Market Committee (FOMC) meets this week (Tuesday and Wednesday, March 18–19, 2014), with Fed Chair Janet Yellen leading the meeting for the first time. At the conclusion of the meeting, Yellen will also hold her first post-FOMC press conference as Fed Chair, and the FOMC will release a new set of economic and interest rate projections.

On the policy side, financial markets do not expect anything new from this week's FOMC meeting. The Fed has made it clear that there is a relatively high hurdle to suspend, speed up, or reduce its plan to taper quantitative easing (QE) by $10 billion at each of the eight FOMC meetings this year. If followed, the plan would see the Fed exit quantitative easing altogether in the fourth quarter of 2014. Although still a long way off, and currently off the stock market's radar for now, three key topics on what the Fed does after QE ends will see an increasing focus by market participants in the coming months:

- When will the Fed raise rates?
- What measures of inflation, employment, and other economic indicators will the Fed be watching most closely?
- How fast will rates rise once rate hikes begin?

A great deal of that conversation will revolve around the FOMC's unwieldy post-meeting statement, an item we have long considered to be at the top of Janet Yellen's to-do list early in her term as Chair of the Fed.

The statement released at the end of the January 28–29, 2014 FOMC meeting was 867 words long and covered six paragraphs. In a world where many of us communicate in text messages and on social media using as few as 140 characters, 876 words seems a bit much, especially since most Fed statements have been around 100–200 words [Figure 1].

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.

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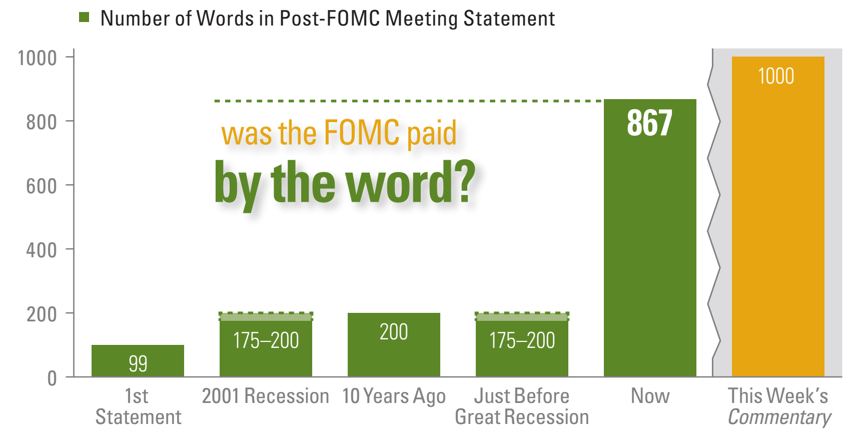
Fed Statements by the Numbers

In early to mid-2007, prior to the onset of the financial crisis and Great Recession, the FOMC statements contained around 150 to 200 words across five paragraphs. The first time the FOMC released a statement after an FOMC meeting was in January 1994. That statement was 99 words long. During the 2001 recession in the aftermath of the bursting of the tech bubble and concerns around deflation, the FOMC statements were generally between 175 and 200 words long. 10 years ago, the March 2004 FOMC statement was 200 words.

1 FOMC Statement: More Words but Less Clarity Over the Past 10–20 Years



Source: LPL Financial Research, Federal Reserve 03/17/14

While more complex economic, financial, and market conditions brought on by the financial crisis and Great Recession clearly warranted a more complex FOMC statement, the length and complexity of recent FOMC statements have become an issue for those inside and outside the Fed. With the worst of the financial crisis and the Great Recession in the rear view mirror, markets seeking some additional clarity about the path of monetary policy in the years ahead are now looking for the Fed to simplify the statement, perhaps as soon as this week. A failure by the Fed to simplify the FOMC statement may lead to even more market uncertainty (and ultimately more volatility) around Fed policy in the months and quarters ahead.

In December 2012, the FOMC modified the statement it released at the end of its policy meeting to include the following language:

> ...the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.

This passage, which contains the oft discussed "thresholds" for keeping rates low has remained part of the statement ever since, and has become known as the Fed's "forward guidance" on rates and monetary policy.

As we have noted many times in recent months, forward guidance is likely to replace quantitative easing as the Fed's main policy tool. With QE likely ending by the end of this year, the Fed has to begin to prepare markets for what that forward guidance will look like, especially since the unemployment rate (at 6.7%), is so close to the Fed's threshold of 6.5%.

The Fed has several options when it comes to the reworking of its forward guidance on rates, and how this guidance is communicated to the markets and the public in the FOMC statement:

- The Fed could decide to abandon the thresholds on the unemployment rate, inflation, and inflation expectations altogether and move to a totally qualitative FOMC statement. In this scenario, the Fed could provide a more detailed range of the economic, labor market, and inflation metrics it is monitoring but not provide specific thresholds on those metrics;
- The Fed could provide the additional metrics noted above and also provide specific targets for each. This seems unlikely, as it would likely increase, not decrease, the complexity (and word count) of the statement; or
- The Fed could leave the numerical thresholds in the statement and also add a list of additional metrics it was watching.

Our view is that the Fed is likely to pursue the first course of action noted above. Whichever course the Fed chooses to pursue with its forward guidance (and there are many beyond the ones detailed here), the market is also at a point where it will want to know — once the Fed decides to raise rates — at what pace and over what time period rates will move higher. This suggests more emphasis on the so-called FOMC dots, which are made public four times a year (including at this week's meeting as part of the Summary of Economic Projections), and aim to capture the views of each of the FOMC members on both the appropriate timing and pace of interest rate hikes.

Whatever the Fed chooses to do this week, we seem to be on the cusp of a new era of Fed communication after more than five years of more and more wordy and more and more complex communications from the FOMC. Financial markets, of course, do not like abrupt change and the uncertainty it brings. Although we don't expect any abrupt change from the Fed this week, the transition from the Fed's easy monetary policy over the past six and a half years to a more normal policy will likely be accompanied by bouts of market volatility, as witnessed during the run up in market interest rates caused by the "taper scare" in the spring and summer of 2013. Thus, the Fed faces a difficult task on the communication front over the next several months and quarters as it continues to prepare markets for the inevitable unwinding of all the monetary stimulus now in the system. ■

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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 U.S. Treasury securities).

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