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Economics Group

Special Commentary

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FOMC: Growth Improves, Policy Steady—Again

FOMC Continues to Support Growth in the No-Fear Inflation Zone

Consistent with the theme of the August meeting, the Federal Open Market Committee (FOMC) in September restated its views that the economy is improving and that the FOMC will continue to "employ a wide range of tools to promote economic recovery and to preserve price stability." Effectively the FOMC will do this by 1) maintaining a zero to ¼ percent target range for the federal funds rate, 2) increasing the size of the Federal Reserve's balance sheet by buying more agency debt and agency mortgage-backed securities, 3) purchasing up to $300 billion of Treasuries through the end of October. The Board of Governors (not the FOMC) will continue the Term Asset-Backed Securities Loan Facility (TALF) to purchase asset-backed securities for credit cards, autos and student loans. Today's Fed action continues the current accommodative policy although a long period of easy monetary policy may generate problems down the road.[1]

Growth: "Economic activity has picked up"

From the view of the FOMC, household spending seems to be stabilizing while remaining constrained by job losses and sluggish income growth. Businesses are still cutting back on investment and staffing. The inventory correction remains ongoing. Our outlook remains for a recovery in consumer spending and industrial production in the second half of this year. Investment spending on equipment & software should turn positive by the fourth quarter. However, employment growth will lag the recovery. The recovery in the domestic private economy is expected to remain below trend as weak growth in real disposable income for consumers and lower profits for non-financial companies dictate a lack of spending power for consumer and investment goods. Growth in the third quarter will be driven by an inventory rebound, federal spending and net exports. Looking ahead, the FOMC expects its policy actions "will support a strengthening of economic growth…in a context of price stability." We agree.

[1] **John E. Silvia, "Financial Green Shoots Today Induce Policy Contradictions Tomorrow," Presentation for the Richmond Association for Business Economics, April 23, 2009.**

Figure 1

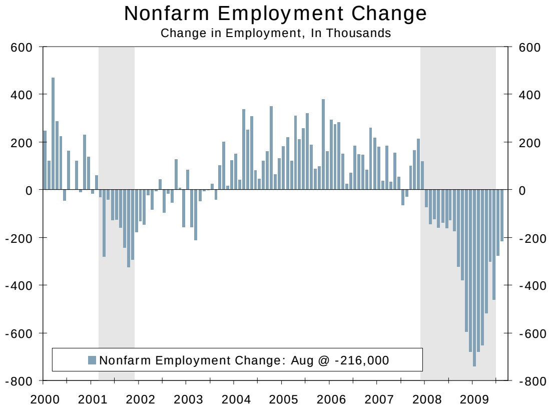
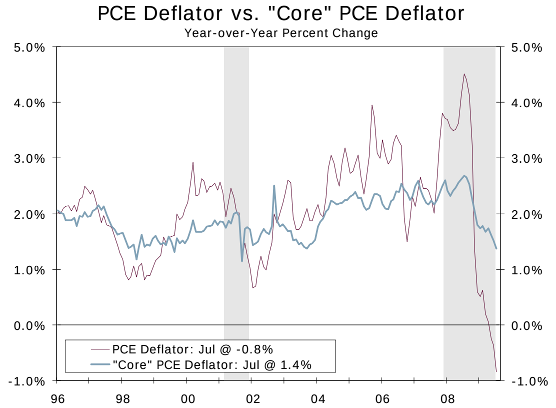


Figure 2



Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities, LLC

Inflation: "Inflation will remain subdued for some time"

The FOMC cited that "With substantial resource slack likely to continue…inflation will remain subdued for some time" Therefore, in our view, inflation, measured by the core personal consumption deflator, will persist for a time below the two percent ceiling rate that the market interprets as the top end of the target range. We expect the core PCE deflator to remain below two percent for the next 12 months. In fact, this has been our view since we published our Annual Outlook in December of 2008.[2] This inflation outlook supports the FOMC statement that "conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period." There is no push from the inflation data for the Fed to alter its easy policy.

Credit Markets: Fed Purchases Continue on Track

The TED spread, an indicator of stress in money markets which had widened to over 400 basis points, now suggests significant liquidity exists at the short-end of the yield curve. At the long-end, credit markets were constrained by the process of seeking a new risk/reward balance. The FOMC actions on agencies and Treasuries are aimed at addressing these longer-maturity/lower credit issues. Today's statement suggests the Fed will withdraw its support in the Treasury market by October but will extend its exit from the Agency market to next March. The Fed, however, recognizes the risks of this strategy, and if needed could slow or even reverse the process.

Figure 3

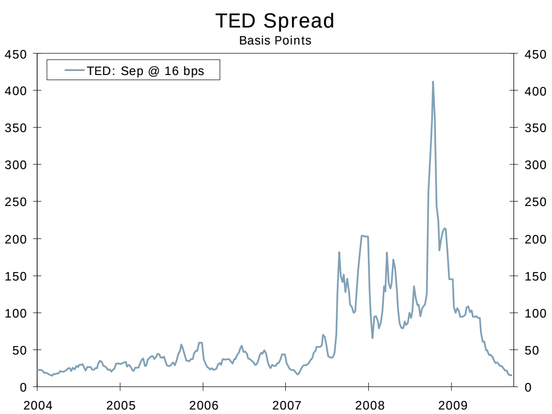
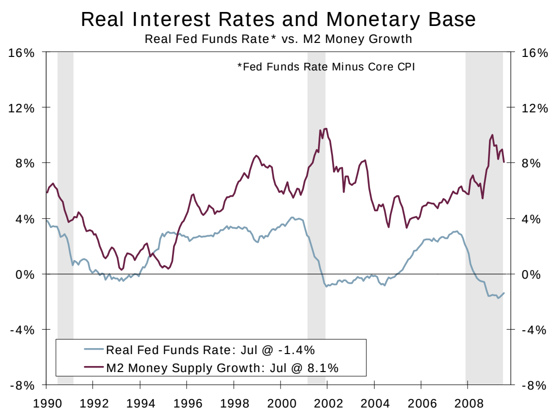


Figure 4



Source: Federal Reserve, U.S. Department of Labor and Wells Fargo Securities, LLC

[2] **2009 Annual Outlook "When Will This Horror Show Come to an End?" December 10, 2008.**

For Decision-Makers: Happy Days in Short-Run—Problems Longer-Term

In response to all this liquidity, the outlook is positive for the economy and credit markets. Longer-term, there remains the concern about too much liquidity and the monetization of Treasury debt. The rapid expansion of the Fed balance sheet and negative real interest rates at the short end of the curve have raised fears that inflation will rise and that sub-four percent ten-year Treasury yields provide inadequate inflation protection. As a result, we expect that ten year Treasury rates will drift upward over the rest of this year. In the short run, Fed easing is a plus. Over the longer run, however, a long period of easy monetary policy may generate more problems with a combination of higher inflation premiums and a weaker dollar. Higher long-term rates are the likely outcome.

For the FOMC, the two objectives of financial stability and economic recovery remain the intermediate-term policy targets. Yet, both targets are a distance away from being reached. The longer-term goal remains price stability with sustainable real economic growth. However, the significant expansion of the Fed's balance sheet in an environment of large federal budget deficits suggests a rising risk profile for an ugly bond/dollar market in the future.

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