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Economics Group

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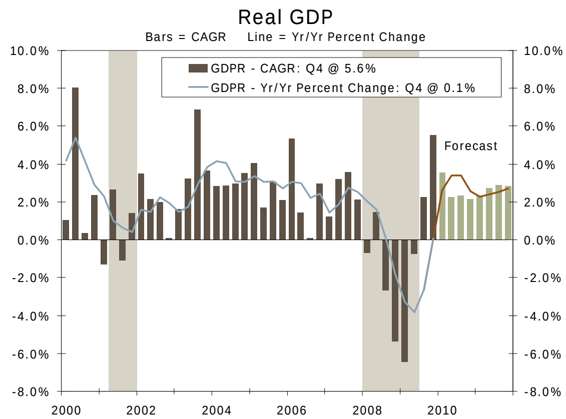
Fed Decision: Holding Steady as the Recovery Matures

Today's FOMC statement again reflected a more optimistic view on the economy with emphasis on improvement in household and investment spending. "Subdued" inflation remains. Dissent continues.

Economic Outlook: Upgraded Again

Economic activity "continued to strengthen" according to the FOMC statement. We agree. Household spending improved with the help of equity price gains and special federal programs. Real positive momentum in the economy is also reflected in export gains and business spending on equipment and software. Orders and shipments reports have improved in recent months as well, confirmed by steady positive readings for industrial production and supplier surveys.

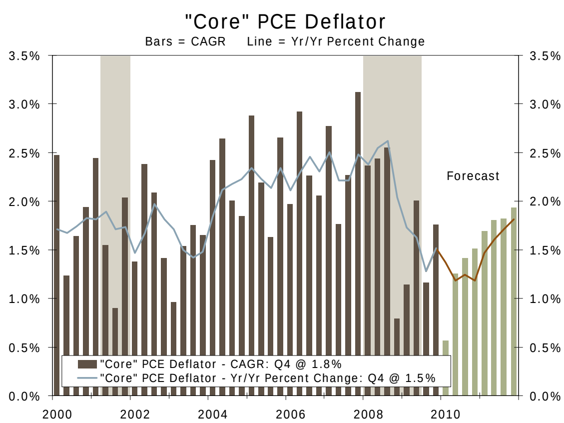
Our outlook for 2010 is for 3.0 percent growth with equipment and software spending up 7 to 8 percent compared to the recession of last year with a drop of more than 15 percent. Two interesting aspects appear in this recovery. First, gains in output are associated with productivity improvements and limited job increases. Second, adding capital equipment without labor suggests a rise in the capital/labor ratio. These two trends suggest increased returns to a smaller existing workforce but limited job opportunities for those without the right skills.



Inflation: Remains "Subdued"

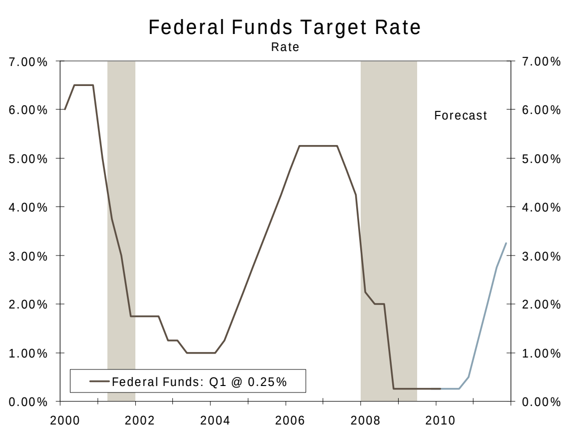
"Substantial resource slack" and "stable" longer-term inflation expectations suggest "inflation is likely to be subdued for some time." Certainly resource slack, if measured by unemployment or capacity utilization, remains substantial. For the near term we do expect the core PCE deflator to remain subdued at less than 1.5 percent or so for the year.

However, we have noticed that inflation expectations have started to rise when gauged by five-year yields and five year forward rates. The rise is still very modest, but enough to move the 10-year Treasury yield upward. Therefore, the yield curve steepened as expected—the Fed keeps short rates low and long rates drift upward as the flight to safety trade goes away and inflation measures edge higher.



Dissent: The Limits to Emergency Fed Easing

Kansas City District President Hoenig's dissent suggests that there was some discussion at the FOMC meeting about the retention of the phrase "extended period" when referring to low levels of the federal funds rate. There has long been debate on the market's expectations for interest rates and expectations for Fed policy that are themselves influenced by Fed comments. By stating "extended period" the Fed may induce economic agents to play the yield curve or the carry trade fairly aggressively and this alters economic activity. During the earlier part of this decade, low rates induced adjustable rate mortgages that later came back to hit borrowers with jumps in payments. Also, an extended period of easy policy could allow the build-up of inflation pressures that would become difficult to control and thereby let the inflation genie out of the bottle.



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

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