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Economics Group

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FOMC: Why The Recent Past Seldom Predicts the Future

Monetary policy will retain its easing stance with the federal funds rate expected to stay low through 2014. A lower inflation rate expectation could open the door to more asset purchases—possibly agency debt.

Past Performance is No Guarantee of Future Anything?

The Federal Open Market Committee (FOMC) retained its outlook for moderate growth and subdued inflation and, thereby, a path of the federal funds rate consistent with those expectations—this is not a forecast. The interest rate path in the future is conditional upon the outcomes for growth and inflation. The Committee extended its timeline for "exceptionally low levels for the federal funds rate at least through late 2014." The FOMC is going with easier policy for a longer period. However, there are risks for decision makers here. The FOMC has opened the door to QE3—see our Weekly Economic Commentary on January 13, 2012.

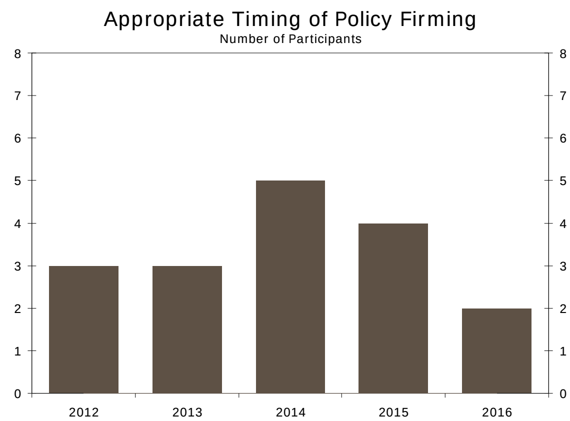
Expectations Change—Often

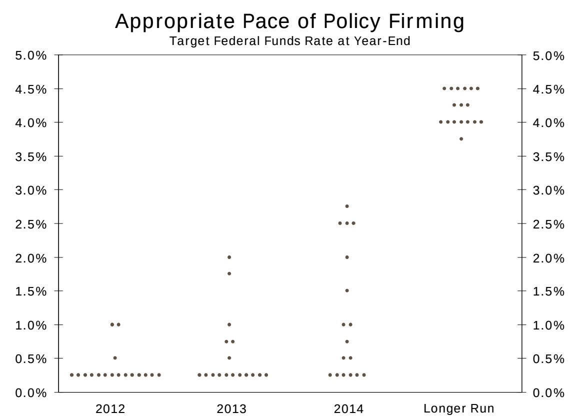
Modest economic growth remains the FOMC's expectation (and ours) over coming quarters and we both agree that consequently "the unemployment rate will decline only gradually." The FOMC again lowered its growth outlook 2012 estimates, this time from 2.5-2.9 percent to 2.2-2.7 percent. Unemployment rate projections were actually lowered to 8.2-8.5 percent.

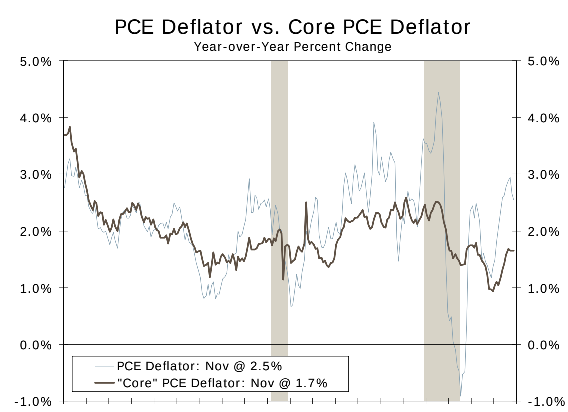
This increases the importance for decision makers to recognize that the outlook for interest rates is dependent on many factors and those factors do change over time. The FOMC projected core inflation at 1.5-1.8 percent for 2012—a touch lower than previous estimates. The long run projection is 2 percent. Our outlook for 2012 is for moderation in the pace of core inflation (bottom graph). At present, the FOMC has decided not to pursue further policy options as many, including us, had expected. Additional security purchases (none dare call it QE3), focusing this time on mortgage-backed securities, remain an option that is aimed at helping the housing market.

The Recency Bias and the Danger for Decision Makers

In the early years of the past decade, many policymakers, including Chairman Bernanke, were talking about the "Great Moderation" in macroeconomic volatility of growth and inflation. Various explanations were advanced for this, including structural change (less manufacturing, more services), better economic policy and good luck. In 2007, the good luck ran out. This is, again, the problem when we tend to extrapolate the latest trend into the future (recency bias) and fail to recognize that the actual path for growth, inflation and interest rates is always in flux and that short-run changes in growth and inflation can lead to sharp movements in equity, bond and commodity prices. Despite the fancy graphs that have been produced, the likely path for interest rates going forward is very likely to be far more volatile than the smooth patterns in those graphs. Therefore, this creates both greater risks and opportunities for investors if "market" expectations become concentrated on the Fed's numbers when the next surprise comes along, as it always does.







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

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