November 02, 2011

Economics Group

John E. Silvia, Chief Economist
john.silvia@wellsfargo.com • (704) 374-7034

FOMC: Continue with "Operation Twist", Growth Moderate

Economic fundamentals dictate a steady Fed policy. Growth at 2.5 percent and core inflation at 2.1 percent defines an economy that awaits the outcomes of the Super Committee and Greek referendum.

Monetary Policy: Continue, with an Easing Bias

As expected, the Federal Open Market Committee (FOMC) decided to continue with the current program of asset sales and purchases ("Operation Twist") based upon its view of the outlook for growth and inflation, as well as the current outlook for risks to the forecast. The Committee reiterated its expectation that current economic conditions "are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."

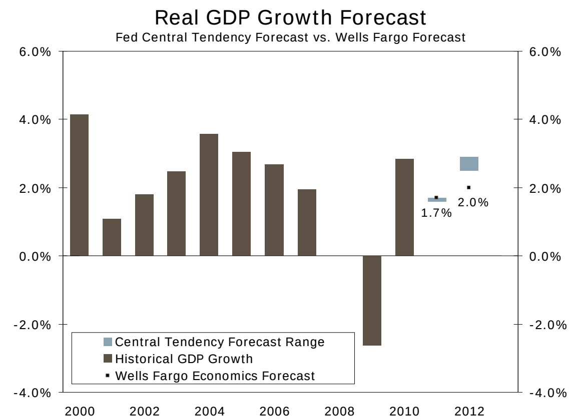
Growth, Inflation and Unemployment

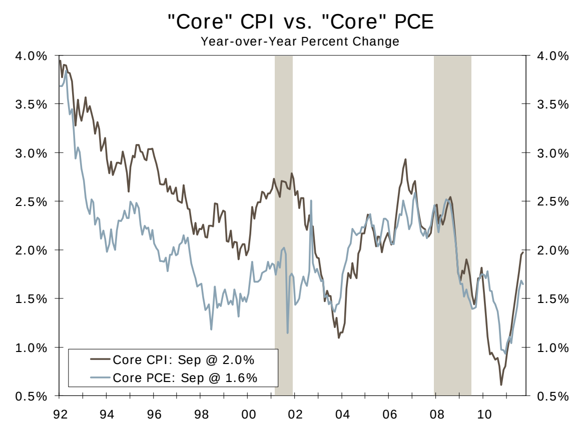
"Moderate pace of growth" is the FOMC's expectation (and ours) over coming quarters (top graph), and "consequently the unemployment rate will decline only gradually." The FOMC sharply lowered its outlook from a June estimate for 2011 of 2.7-2.9 percent to 1.6-1.7 percent, 2012 estimates were lowered also from 3.3-3.7 percent to 2.5-2.9 percent. Unemployment rate projections were raised for both years as well. "Household spending has increased at a somewhat faster pace" and "business investment in equipment and software has continued to expand," while the "housing sector remains depressed." As for inflation, the FOMC "anticipates that inflation will settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate." The FOMC projected growth for the core inflation rate at 1.5-2.0 percent for 2012. Our outlook for core inflation during 2012 is for moderation in the pace of inflation.

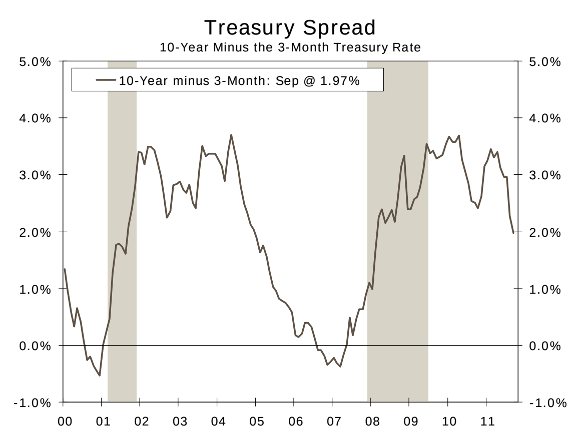
Options Going Forward

At present, the FOMC has decided not to pursue further policy options, as many, including us, had expected. Given the uncertainties surrounding the Super Committee's fiscal recommendations and the Greek referendum, this appears to be a thoughtful approach. Three options are on the table for discussion if the Fed decides to ease further: 1) further guidance 2) cut the interest on reserves from 0.25 percent to a lower level; and 3) additional security purchases (QE3)–focusing this time on mortgage-backed securities to help rejuvenate the moribund housing market.

We believe that the economic conditions do not support the pursuit of any of these options for now. With real GDP growth around 2.5 percent and core inflation currently above the Fed's "target", we believe the FOMC will wait and monitor the fourth-quarter data before making any move in early 2012. Given Chicago Fed President Evans' dissent, the FOMC would likely accept higher inflation (3.0 percent) in order to ensure faster economic growth in the short run. Furthermore, the FOMC appears that it anticipates that policy can reverse itself enough to avoid an inflationary spike. Bottom line, the FOMC is ready to stand aside and let the expansion continue for a while, awaiting developments from Capitol Hill and the Acropolis.







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

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wellsfargo.com
Scott Anderson, Ph.D.	Senior Economist	(612) 667-9281	scott.a.anderson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(704) 715-0314	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Senior Economist	(704) 383-7372	sam.bullard@wellsfargo.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wellsfargo.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economist	(704) 374-4407	tim.quinlan@wellsfargo.com
Michael A. Brown	Economist	(704) 715-0569	michael.a.brown@wellsfargo.com
Joe Seydl	Economic Analyst	(704) 715-1488	joseph.seydl@wellsfargo.com
Sarah Watt	Economic Analyst	(704) 374-7142	sarah.watt@wellsfargo.com
Kaylyn Swankoski	Economic Analyst	(704) 715-0526	kaylyn.swankoski@wellsfargo.com