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Economics Group

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The Fed: Same Goal, Different Method

Traditionally, monetary easing has been characterized by lowering short-term rates and altering the size and duration of the Fed's balance sheet. In contrast, 2012 has been the year of speeches.

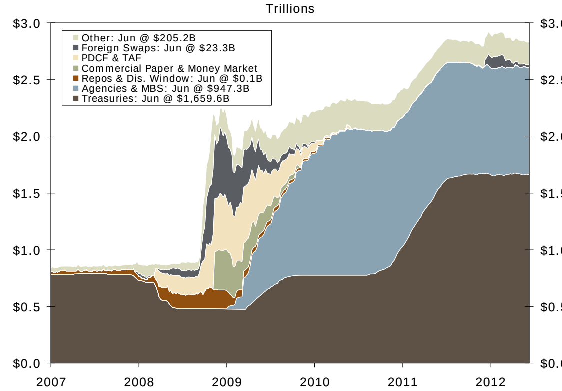
Shall We Twist Again?

We have been here before—uncertainty against the backdrop of moderate economic growth and significant downside risks. Even with the uncertainty of the Greek election behind us, the steady flow of Eurozone news will continue to cast doubt in the markets as the Eurozone attempts to create a fiscal union and insolvency issues remain center stage. Moreover, with U.S. economic data coming in weaker than expected, some are questioning whether the three-year U.S. recovery is stalling. That said, the FOMC meeting on June 20 will go a long way in making clear that the Fed will use whatever tools in its arsenal to reassure financial markets that it stands ready to provide liquidity if needed.

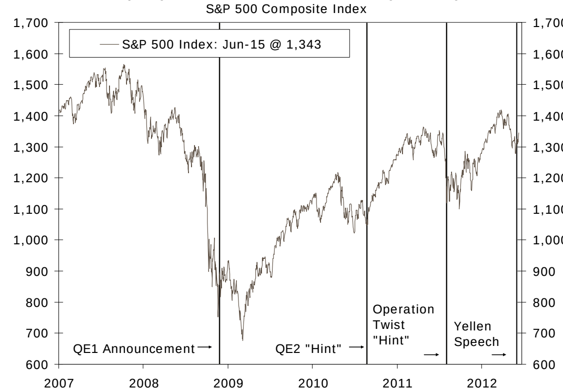
Up until this point, the Fed has employed two main accommodative measures outside of lowering rates to its zero-lower bound: it has extended forward guidance regarding the path of the federal funds rate and has increased the size and duration of its portfolio through large-scale asset purchases commonly known as quantitative easing and Operation Twist. With Operation Twist scheduled to expire at the end of June, the biggest question on investors' minds is whether the Fed will institute another round of easing. We suspect the FOMC will announce an extension of Operation Twist, where the size of the balance sheet is maintained by continuing to sell short-term securities and buy long-term securities. The first roll out of Operation Twist appeared to be successful, with the markets pricing in additional easing even prior to the official announcement (for additional commentary see, "Has the Fed's Unconventional Approach Been Successful?" which is available on request) Moreover, even though short- and long-term rates are at record lows, at this stage of the recovery it less about low interest rates and more about investor sentiment.

Over the past two weeks, to help boost investor sentiment and quell some of the anxiety regarding uncertainty around the Greek election and weaker-than-expected economic data releases, the Fed has used public speeches as its most recent monetary tool. To be more explicit, in one speech Fed Vice Chair Janet Yellen recently noted that, "if the Committee were to judge that the recovery is unlikely to proceed at a satisfactory pace, or that the downside risks to the outlook had become sufficiently great, or that inflation appeared to be in danger of declining notably below its 2 percent objective," she is "convinced that scope remains for the FOMC to provide further policy accommodation." While the Fed's dual mandate is limited to maximum employment and stable inflation, perceived risks could affect the Fed's twin goal in the short term. That said, headline risks will continue to cause market volatility throughout the year, but the Fed has made it clear it will use all of its tools to reach its goals.

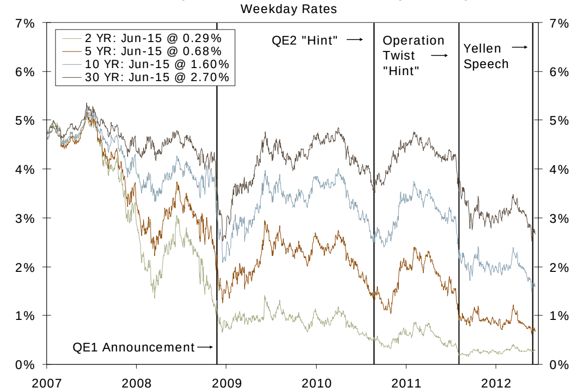
Federal Reserve Balance Sheet
Trillions



Equity Market and Monetary Policy
S&P 500 Composite Index



Treasury Yields and Monetary Policy
Weekday Rates



Source: Federal Reserve Board, Standard & Poor's and Wells Fargo Securities, LLC

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