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Economics Group

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FOMC Maintains Weak Growth, Low Inflation Outlook

Given the FOMC's outlook on growth and inflation, easy policy will remain in place and thereby support our view of continued low short-term rates through 2014, but long-term rates will drift upward.

Fed Still Easy, But We are Skeptical Policy Will Boost GDP Much

Even with QE3 continued over the forecast horizon, we maintain our outlook for sub-2 percent growth in the second half of this year and throughout 2013. Weak job gains and wage gains below the pace of CPI inflation remain the challenge for consumer spending. Meanwhile, weakness in Chinese and European growth expectations, as well as policy uncertainty in the United States, has led to weakness in capital goods orders and business investment, which the Federal Open Market Committee (FOMC) recognized in its statement today. Meanwhile, corporate profit growth continues to slow, thereby limiting gains in both personal income and business investment going forward. We are more cautious on the economic outlook than the FOMC (top graph).

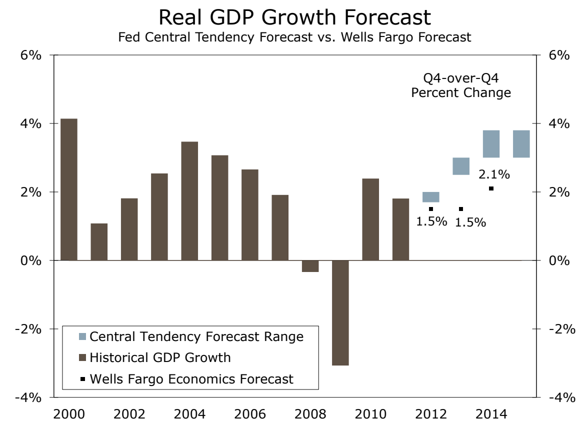
We expect that the FOMC will maintain its extended interest rate guidance from late 2014 to mid-2015 and its open-ended $40 billion per month mortgage-backed securities (MBS) bond-buying program. While Operation Twist expires at year's end, we believe the $45 billion per month gap left from the expiration of Operation Twist will be filled by increased Treasury purchases of an equal amount. Bottom line, we expect today's $85 billion per month security purchases to be maintained for the foreseeable future.

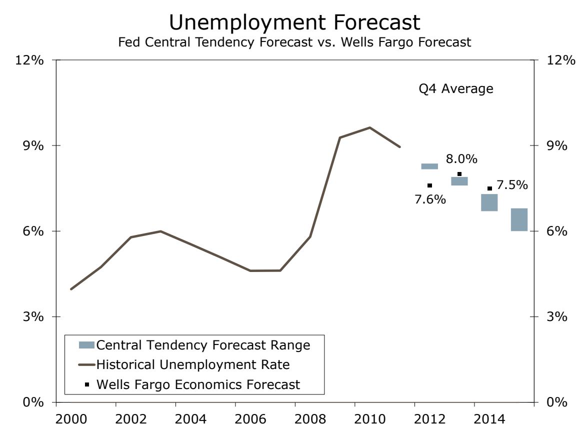
In the FOMC's guidance, they maintained their view that if labor market conditions do not improve "substantially," the Fed would continue the MBS bond-buying program and potentially undertake further easing measures. Moreover, the Fed "expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens." Bottom line, whenever rates do rise, we should expect a more gradual-than-normal tightening process to unfold.

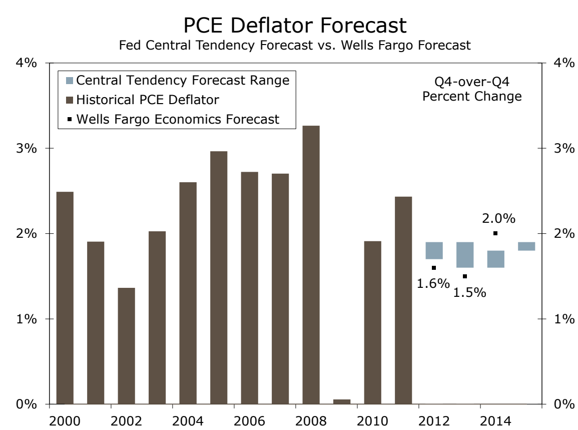
What About the Unemployment Rate as a Policy Target?

At the September FOMC meeting, the Fed downgraded its view of current economic conditions and also scaled back its expectations for the near-term economic outlook. Today's policy statement still sees the U.S. economy expanding "at a moderate pace," but makes note of the slowdown in business fixed investment and "elevated" unemployment. We remain less optimistic on the reduction in the unemployment rate relative to the FOMC (middle chart).

With all but two Fed officials expecting the long-term target federal funds rate to remain below 4 percent, the FOMC's forecast is an unspoken admission that the economy's long-term potential growth rate has slowed substantially. The Congressional Budget Office's long-term GDP forecast is around 2.2 percent, a number that seems reasonable to us. Addressing the nation's fiscal budget problems and reducing the unemployment rate in a 3.5 percent GDP environment was going to be tough enough. If the U.S. economic performance turns out to be as low as many expect, the challenges facing our nation will be considerably more difficult.







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

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