Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist

TRENDMACRO LIVE!

# On the May FOMC

Wednesday, May 1, 2013

**Donald Luskin**

**The Fed acts oblivious to a here-and-now deflation threat, and deteriorating data.**

Fedwatchers seem to be focusing on an entirely new sentence in today's FOMC statement: "The Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes." But this means nothing -- we have always known the Fed would vary the program. It's not even the first time the Fed has overtly said it might make additional asset purchases -- it used those very words in last September's FOMC statement when QE3 was announced (see "On the September FOMC" September 13, 2012).

- *What's really notable about today's statement is that there is no language change whatsoever to deal with the fact that inflation has fallen to levels which, previously, would have put the Fed on high alert for deflation* (please see the chart below).
- Core personal consumption expenditures inflation (ex food and energy), now at 1.13% year-over-year, is the seventh lowest reading in the 53-year history of the data.
- *It is lower* than in November 2002 when Ben Bernanke was so worried about deflation that he gave his infamous "helicopter"

**Update to strategic view**

**US FED, US MACRO:** Markets shouldn't draw comfort from the Fed's statement that it might "increase" asset purchases -- it was in the context of an obvious and very general promise to "increase or reduce" asset purchases based on new information. Outright discomfort should be taken by the Fed's apparent obliviousness to the looming risk of deflation with core inflation, here and now, lower than…

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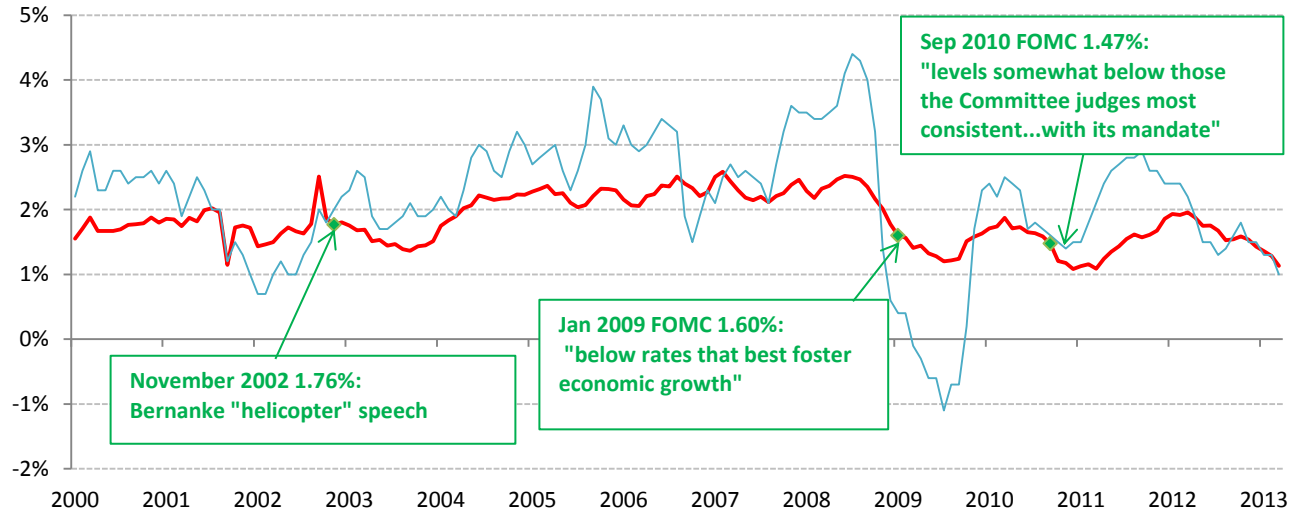
**Personal consumption expenditures inflation, YOY — All items — Core (ex food and energy)**



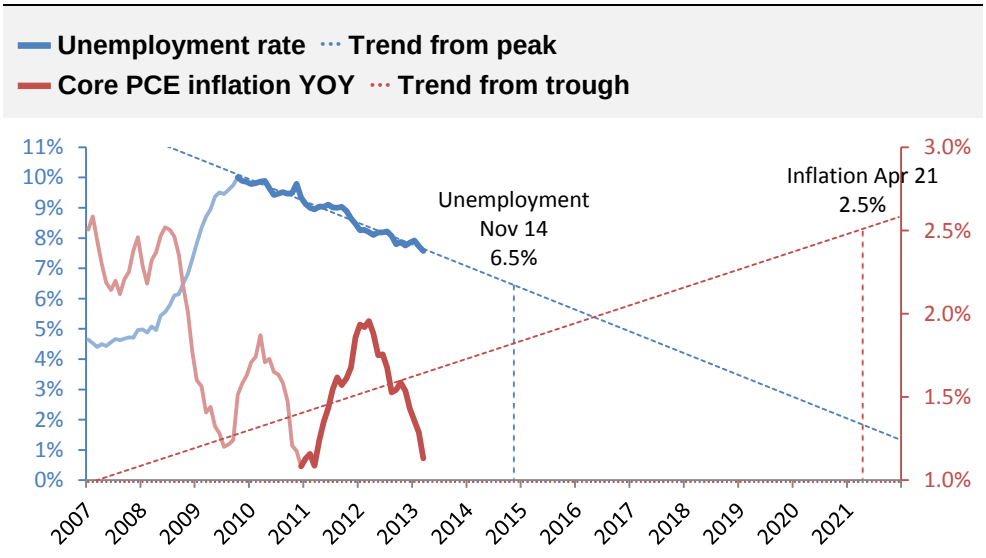

Source: BEA TrendMacro calculations

speech about it.

- *It is lower* than it was in 2009 and again 2010 when deflation served as the Fed's rationale for QE1 (see "Ben Boldly Goes" March 19, 2009) and QE2 (see "On the November FOMC" November 3, 2010).
- All the FOMC statement said about it today is precisely the same as in the prior meeting's statement: "Inflation has been running somewhat below the Committee's longer-run objective, apart from temporary variations that largely reflect fluctuations in energy prices. Longer-term inflation expectations have remained stable."
- Yes, energy prices (and other commodity prices) have fallen -- indeed, spectacularly so of late (see "Gold and Commodities: Breaking Bad" April 15, 2013). But this is only a distraction from the fact that *core* inflation -- that is, without energy or food -- has sharply fallen, too.
- There have been times over recent years when the Fed has ignored rising headline inflation, taking comfort from more quiescent core inflation. *Whether or not that logic was ever valid, it surely isn't now -- headline and core inflation are falling, here and almost everywhere else in the world.*

The FOMC didn't only ignore the clear and present threat of deflation. Overall, changes in the FOMC language were very few (for a line-by-line log of all changes, please see "Data Insights: Federal Reserve" May 1 2013), with really no acknowledgement at all that macroeconomic data has deteriorated markedly after a moderately strong start in January and February (see "On Q1 GDP" April 26, 2013).

- In March the FOMC said, "Information…suggests a return to moderate economic growth following a pause late last year." Today it was: "economic activity has been expanding at a moderate pace."
- It's not clear whether the FOMC can see that, pretty much without exception, macroeconomic data went into decline in March.




Source: BLS, BEA, TrendMacro calculations

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…when Bernanke gave his "helicopter" speech about it, or when it inspired QE1 and QE2. The Fed seems adrift, ignoring this obvious risk, and making no comment about the deterioration of macro data in March. With time to reflect, markets ought to begin to worry about how bad things have to get before the Fed acts -- or even notices.

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Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland

We're getting no clarity now from the so-called "Evans Rule". It would appear that unemployment is reliably inching its way toward the rule's 6.5% trigger for rate hikes, and It looks like it will get there in November 2014 (please see the chart on the previous page).

- The rule, a seeming exemplar of clarity in policy communications when it was announced in December (see "On the December FOMC" December 12, 2012), now appears to be so mis-specified as to be useless.
- While providing an upside trigger on inflation at 2.5%, it doesn't look like that will be achieved until April 2021 (again, see the chart on the previous page). As to the downside, where inflation seems like it's heading right now, the rule is silent. *At what point is inflation so low that it triggers a Fed response?*
- While providing a downside trigger on unemployment at 6.5%, even the mainstream non-financial media now completely understands that this is a meaningless statistic given the historic drop in the labor force participation rate. *At what unemployment rate will the Fed have fulfilled its statutory mandate for "maximum employment"?*

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**Bottom line**

Markets shouldn't draw comfort from the Fed's statement that it might "increase" asset purchases -- it was in the context of an obvious and very general promise to "increase or reduce" asset purchases based on new information. Outright discomfort should be taken by the Fed's apparent obliviousness to the looming risk of deflation -- with core inflation, here and now, lower than when Bernanke gave his "helicopter" speech about it, or when it inspired QE1 and QE2. The Fed seems adrift, ignoring this obvious risk, and making no comment about the deterioration of macro data in March. With time to reflect, markets ought to begin to worry about how bad things have to get before the Fed acts -- or even notices.