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

TRENDMACRO LIVE!

On the June FOMC

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Donald Luskin

One dissent over inflation risk. Another over deflation risk. And by the way, no tapering.

Turns out we were correct to go against widespread expectations that today's FOMC statement would include some indication that Large-Scale Asset Purchases (LSAPs) will be "tapered" later this year (see "To Taper or Not to Taper?" June 7, 2013). But in his opening statement at his post-meeting press conference, Fed Chair Ben Bernanke did clearly outline how asset purchases could indeed be reduced late this year and decelerate to zero by mid-2014 as the unemployment rate falls through 7% on its way toward its so-called "Evans Rule" threshold of a 6.5%. He was emphatic both that this is "not a change in policy," and is completely contingent on evolving data. It is perfectly consistent with the sequencing and cause-and-effect scenario we outlined at the beginning of the year, based on the tightly correlated downward trend of the unemployment rate (see "2013 Outlook: Doves Ruled Out at the Fed" January 25, 2013).

- After all the fretting about an impending tapering announcement, today's FOMC statement was almost entirely unchanged from the prior meeting's (see "Data Insights: Federal Reserve" June 19 2013).
- Of the two changes that were made, one reflected precisely what we've characterized as the key shift in the Fed's attitude since QE3

Update to strategic view

US FED, US BONDS: We were right to doubt that today's FOMC statement would indicate "tapering" dead ahead. In the press conference Bernanke was clear that it is coming eventually, though, as unemployment glides toward its "Evans Rule" threshold next year. The FOMC now sees a less risky world than it did in September when QE3 was launched, and so do rising yields in global bond markets -- which Bernanke himself calls "a good thing."

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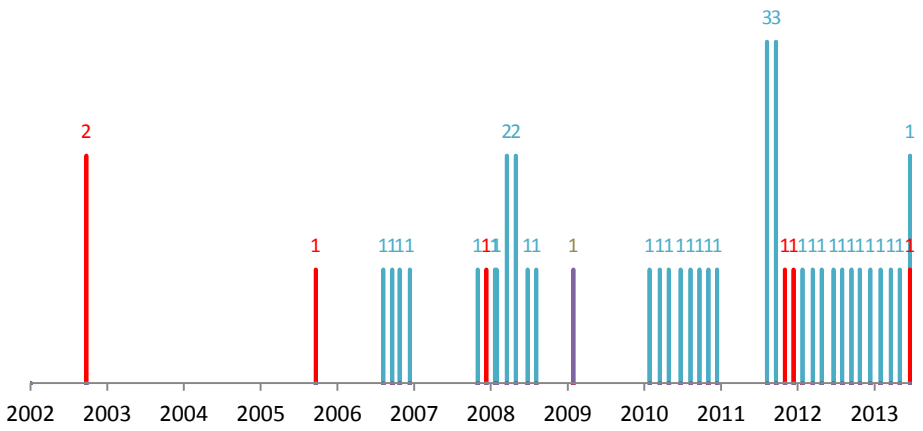
Number of FOMC decision dissents — **Dovish** — **Hawkish** — **Procedural**



Source: Federal Reserve, TrendMacro calculations

was introduced last September toward less fearfulness about the global economy. It doesn't get any clearer than this new language:

> "The Committee sees the downside risks to the outlook for the economy and the labor market as having diminished since the fall."

- The only other language change was to blame nameless "transitory influences" for the fact that "inflation is running below the Committee's longer-run objective."
- At the prior meeting, before core PCE inflation fell to the lowest level in the history of the data, it was characterized as only "somewhat below."
- But that tip of the hat to increasing deflation risk wasn't enough to satisfy St. Louis Fed President James Bullard. He dissented in today's vote, because he "believed that the Committee should signal more strongly its willingness to defend its inflation goal in light of recent low inflation readings…"
- So we have something quite unique. With Kansas City Fed President Esther George's dissent because present policy "could cause an increase in long-term inflation expectations," we have simultaneously a dovish dissent and a hawkish dissent (please see the chart on the previous page).
- If the markets were frightened by the deflationary risks arising from the FOMC's generally insouciant view on falling inflation -- Bullard notwithstanding -- we wouldn't have seen the US 10-year yield move to a new recovery high following the statement. If deflation were a risk, yields would be falling, not rising.
- Moreover, if the markets were frightened by the growth risks arising from the prospect of decelerating LSAPs, again, yields would be falling, not rising.
- So ruling out a deflationary error, we continue to interpret the back-up in rates over the last several weeks -- accelerating a turnaround that began almost a year ago -- as the market's recognition of the same thing the Fed is seeing now: that it's a less risky world now.
- We agree, then, with Bernanke's observation in his press conference. In such a context, higher interest rates would be "a good thing."

Bottom line

We were right to doubt that today's FOMC statement would indicate "tapering" dead ahead. In the press conference Bernanke was clear that it is coming eventually, though, as unemployment glides toward its "Evans Rule" threshold next year. The FOMC now sees a less risky world than it did in September when QE3 was launched, and so do rising yields in global bond markets -- which Bernanke himself calls "a good thing."

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
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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
617 600 6969
lorcan@trendmacro.com

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