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Commentaries and Insights from Allawos & Company

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"Economic Predictions for 2015?"

The Honorable Ken Herman, ***International Economist, Henderson, Nevada***

At the most recent Federal Open Market Committee meeting, the Fed staff and FOMC members remain committed to raising rates next year. The minutes offer insight into why.

First, it is clear from the staff review and outlook no one is worried about inflation in 2015 or 2016, or even 2017. **The inflation the Fed will be tightening to prevent next year is a longer-run threat, one not likely to materialize until 2018 or later. That's important, because the decision to raise rates next year will be just as forecast-dependent as it is today.**

The Fed's inflation forecast is based on two things; labor market slack and inflation expectations. On the expectations front, the staff notes the recent drop in market-based measures of inflation expectations, but raises the possibility the drop could be anomalous, reflecting a lack of liquidity or other technical problems in the market. "Survey based measures of inflation expectations," they say, "remained well anchored." This was indeed true at the time of the Fed meeting, but in the October University of Michigan consumer sentiment survey, released recently, long-term inflation expectations plunged to their lowest since 2009. That's meaningful, because the survey tends to be rock steady. Since 2009, it has been locked in a 2.7%-3.0% range.

As for labor market slack, confusion reigns. Some see the elevated level of people working part time for economic reasons as evidence of more slack than is reflected in the unemployment rate, others point to labor market super indices (made up of dozens of series) showing slack coming out of the

market. What is conspicuously missing is anyone with an opinion of how we'll know when there is inadequate slack.

There were further clues to what members are thinking in the forward guidance discussion. A couple of participants wanted to amend the language in reference to the pace of tightening once liftoff is achieved "in light of the prescriptions suggested by many monetary policy rules and the risks associated with keeping interest rates below their longer-run values for an extended period of time." This, of course, is a Taylor Rule reference. The Taylor Rule in economics stipulates how much the Central Bank should change the nominal interest rate in response to changes in inflation, output, or other economic conditions.

The last time the Taylor Rule was mentioned in the Fed minutes was March, when one participant thought the FOMC should explain why it was holding the fed funds rate low "when standard policy rules were prescribing that the rate be increased."

See the difference? In March someone wanted to keep rates low *in spite of* the Taylor Rule. Now, more than one wants to omit the promise to keep rates accommodative even after starting to tighten for a considerable period *because of* the Taylor Rule.

Wall Street's forecast is for continued moderate growth in the economy and employment. My colleagues on Wall Street have decided to listen to what the Fed says it will do rather than trying to impose their will on the Fed, though many are somewhat nervous that if the Fed really is intending to raise rates in the middle of next year, Yellen's tightening warning in the first quarter could have the same kind of market impact as Bernanke's taper warning did last May, perhaps resulting in a similar delay. Wall Street has built a short term bump in yields into the forecast with this in mind.

The Fed remains committed to its employment and inflation forecast and next year's planned rate hikes. Competitive devaluation, possible recession in Europe, the China credit and growth slowdown, Ebola, widespread geopolitical fires, and lower energy prices will help restrain inflationary trends; the Fed's current year forecasts tend to be more reality based.

Yes, Quantitative Easing has ended, in the US anyway, but that doesn't mean the Fed is done buying bonds. They are already buying MBS at a rate of $20-25bn a month in order to keep their holdings constant, a rate that will speed up or slow depending on the pace of refinancing. Treasury purchases won't begin until next year when the Fed will have to replace about $200bn that will roll off. To put it into perspective, combined Treasury and Mortgage Back Security purchases next year will be at about 2/3 the pace of bond buying under QE2.

GDP recently rose 3.5%, more than the 3.0% consensus, thanks to an unexpected drop in imports and rise in exports.

FOMC members are likely to feel vindicated about their decision not to back down from their hawkish stance. The dollar is stronger, indicating traders are slightly increasing the odds of faster action from the Fed, but yields are little changed. Looking forward, the strength of the dollar is likely to erode exports and boost imports in future quarters. Inventories are likely to slow, but consumption is likely

to pick up a bit. On balance, Wall Street's Q4 estimate is for growth of 2.5%-3.0%, leaving growth for 2014 as a whole at 2%.

With the above statements, all bets are off if there is a major geopolitical event or further world security issues destabilizing the world markets.

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