



The Fed Plays for Time— Predictably*

“The first increases in short-term rates might not occur until the unemployment rate is considerably below 6.5 percent”!

Ben Bernanke, Sept. 18, 2013

The Fed has dared to act contrary to expectations—and rightly so. This was no easy move, given that since early summer the markets have talked themselves into believing that central bank policy was about to change. Yet the reasoning behind the FOMC decision couldn’t be clearer:

- 1- The U.S. economy is still on extremely shaky ground. Growth has yet to pick up; job gains remain mediocre; disposable income is still too low to drive a lasting recovery in consumer spending; and businesses are not investing.
- 2- Yields have risen so sharply since the start of the summer that they have come to pose a threat to growth, as demonstrated by the sudden halt to the housing market uptick since the spring.
- 3- The lower jobless rate doesn’t reflect improvement in labor market conditions. If anything, it shows that they have continued to get worse. The labor force participation rate is in free-fall—in other words, more and more working-age people are simply dropping out in discouragement.
- 4- Fiscal policy is highly restrictive and will remain so—just when implementation of health-care reform prior to year-end is likely to take a large bite out of personal income.

*See [“Bernanke and the Fool’s Gold of Falling Unemployment”](#), July 5

[“The Upcoming Fed Meeting: Playing for Time”](#), August 19

[“The U.S. Economy: Far Too Early to Break Out the Champagne”](#), September 16

An Announcement With Major Implications

The September 18 announcement has made up for the Fed's previous regrettably vague communication policy, dictated in early summer by a number of concerns with little connection to the underlying state of the economy. These included the desire to keep what resembled a bond bubble from inflating, smooth the central bank's own leadership transition, and bridge differences between Fed Board members. However legitimate they may have been, those concerns rapidly triggered a spate of market expectations that the Fed needed to temper. And temper them it did—in a timely, energetic way.

Not only has the Fed just emphasized that it will not be scaling back its asset purchases any time soon; it has also lowered its forward guidance on growth and put a stop to speculation (of its own making) about its twin unemployment and inflation targets, stating:

- 1) that the first increases in short-term interest rates might not occur until the unemployment rate is considerably below 6.5 percent;
- 2) that the Fed will be reluctant to raise its rates until the inflation rate exceeds the target set by the Fed itself!

The conclusions we draw from this latest FOMC meeting give much greater weight to our forecasts than in even our wildest dreams:

- 1- The Fed's key rates won't be going up prior to 2015—at the earliest.
- 2- Current market expectations have lost their validity and are therefore poised for correction. Long-term yields should fall by enough to wipe out most of the increase recorded since the spring. We are therefore maintaining our forecast for 10-year yields in the 2.30 to 2.50 percent range.
- 3- Two-year yields, which were on their way up, can be expected to edge back down.
- 4- The dollar is likely to lose the ground it recently gained, returning in short order to around 1.35 against the euro. The decrease may even prove to be much greater if the Fed's balance sheet keeps expanding vigorously and 2-year yields subside.
- 5- This reduces the risk of a U.S. downturn in 2014 ...
- 6- ... and increases the likelihood of an eventual inflationary exit strategy.

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