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ECONOMIC TALKING POINTS

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Flash Note: What Were They Thinking?

The Federal Reserve blew it. The statement at the conclusion of the FOMC made no mention of the economy gathering momentum. It made no mention of the tax compromise that will likely stimulate more consumer and business spending next year. It offered no explicit comment that the full QE2 may not be necessary, even as virtually every forecaster is raising their GDP growth numbers for this quarter and 2011. Incredibly, the Fed did note right up in the first graph “longer term inflation expectations have remained stable...”

Stable? That comment defies reality because rates on 10-yr Treasury notes are up 90 basis points in the weeks since the FOMC met last on November 3rd. Today they went up another 16 basis points, to 3.44%.

So here’s the question: Did these rates move higher because the economy is getting stronger – or because bond investors fear the Fed is about to err by continuing to pump too much money into an economy that is in the midst of accelerating? Our concern is it’s the latter.

Look, the Fed admittedly has a very difficult task. They want inflation to edge closer to 2%. Presently, core CPI is up 0.6% and core PCE is at 0.9% year over year. In addition, the Fed is working hard to lower the unemployment rate. We get all that. But

the Fed also has to keep its eye on the bond market and reassure investors that it is aware the economy is gaining speed. They should have inserted a statement raising the possibility that the full $600 billion may not be needed **IF the economy continues to strengthen.**

By totally ignoring the growing anxieties of bond investors in the Fed's statement, the central bank risks committing a strategic mistake. If investors conclude the Fed is too focused on carrying out QE2 without ever acknowledging the improvement in economic activity, it sets the stage for a sell-off in bonds that could escalate globally. One way to get around this in the short term is for Fed officials to articulate in upcoming speeches that the economy looks better and that this may obviate the need to fully implement QE 2. Without such words, bond investors, who see more vigorous economic growth **AND** the continuation of a loose monetary policy, could act first with a vote of no confidence in the Fed by dumping fixed incomes. Any stampede for the exits by bond holders will likely thrust rates to levels that can potentially abort the recovery.

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