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ECONOMIC TALKING POINTS

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QUICK NOTE:
A fairly benign FOMC statement. But Yellen will now have her hands full.

The only change of any significance in today's FOMC statement can be found in the first graph.

> "Information received since the Federal Open Market Committee met in December indicates that growth in **economic activity picked up in recent quarters. Labor market indicators were mixed but on balance showed further improvement.** The unemployment rate declined but remains elevated. **Household spending and business fixed investment advanced more quickly in recent months,** while the recovery in the housing sector slowed somewhat. Fiscal policy is restraining economic growth, although the extent of restraint is diminishing. Inflation has been running below the Committee's longer-run objective, but longer-term inflation expectations have remained stable."

The gist of this report tells us that the Fed believes the US economy is actually gaining more traction, and that the financial crisis facing certain emerging countries is unlikely to derail that progress.

In addition, the Fed appears to have largely dismissed (and rightly so) the weak preliminary December jobs report.

And so, with this final report from the FOMC under the leadership of Ben Bernanke, we now turn to Janet Yellen and the challenges she will face.

Are there any risks or bubbles emerging that should warrant concern?

Certainly Yellen will have to keep a close eye on how China handles the growing threat of defaults in the shadow-banking sector. If history is any guide, however, we do not see those debt problems escalating to the point of triggering a global systemic financial crisis. China has two advantages few other countries have: It has $3.8 trillion in foreign exchange reserves it can tap if necessary. Second, as an autocratic government, China can respond much faster than liberal democratic governments in dealing with an emerging crisis. The ruling Politburo has demonstrated that ability on numerous occasions during past global economic storms. (Remember, China barely suffered any fallout from the Asian debt crises, Russian bond default, the dot.com bust of the last decade, and the latest global recession.)

It is, however, on the domestic front that Yellen may soon find more vexing problems.

• **Margin debt** among investors is at an all time high of $445 billion and still climbing rapidly. A major pull back in the stock market could create serious financial strains for those borrowers, and perhaps trigger an even steeper decline in equity values.

• **Home prices** (based on the Case Shiller price index) keeps surging at double-digit annual rates, while general inflation and disposable personal income barely budges. Indeed, the last time we saw such a gap between home prices (rising 13.7% YOY) and disposable personal income (1.5%) was in 2006, on the eve of the real estate crash.

• The **explosive growth in both student debt and delinquencies** also has to be worrisome. Student loans have tripled in the last 8 years to more than $1.2 trillion. It comes second in magnitude after home mortgages. Rising student delinquencies and defaults could harm future consumer spending and home sales. It might even scare people away from higher learning and thus affect employment growth and US productivity.

• Lastly, Yellen has to be concerned that with the economy getting stronger, there is the chance banks may move more quickly to convert some of their $2.4 trillion in **excess reserves into credit.** If so, that would raise the specter of inflation and heighten fears that Yellen is behind the curve in preventing that very danger.

Bottom line:

The latest FOMC statement portrays a fairly benign picture of the US economy. But given the potential risks ahead, Yellen will have her hands full to make sure this is not simply the quiet before the storm

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