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ECONOMIC TALKING POINTS

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A December lift off on rates looks more likely. But will the yield curve flatten afterwards?

In the final analysis, FOMC members had to address two broad questions.

First, is the US sufficiently insulated from the foreign economic mess so that a slowdown overseas will not imperil the US expansion?

The answer to that is yes, though the statement was not that forthright. (Today's FOMC report: *"Household spending and business fixed investment have been increasing at* ***solid rates in recent months," ---*** vs.---September's more modest assessment: ***"****Household spending and business fixed investment have been increasing moderately.")*

Translation: While American manufacturers and the energy industry have scaled back capital expenditures and hiring, the rest of the domestic economy continues to demonstrate healthy fundamentals. Consumers are buying cars at the fastest pace in a decade and happily eating out at restaurants. Both reflect a high level of discretionary spending, behavior and that follows an improvement in job and income security.

The second broad question before the Fed was the timing of a Fed rate hike --- and here we suspect politics played a whispered role. Does the central bank, a favorite a target of criticism by many in Congress, really want to begin its first monetary tightening cycle in ten years smack in the middle of a heated presidential campaign? I would think not. If anything, Fed policymakers would prefer to keep as low a profile as possible this coming election year.

We therefore noted in the FOMC statement a real preference for acting in December.

"In determining whether it will be appropriate to raise the target range ***at its next meeting,*** *the Committee will assess progress--both realized and expected--toward its objectives of maximum employment and 2 percent inflation."*

Translation: In the absence of any major deterioration in US economic activity, December is the month the long drum roll to raise rates finally comes to an end. After all, the recovery is now in its 7th year, the unemployment rate stands at a 7.5 year low, employers are seeking to fill a near record number of positions, claims for jobless benefits are at 40 yr. lows, core inflation is crawling up, housing is in recovery mode, and GDP growth continues to hover around 2.5%. There is no justification for keeping rates at the emergency level of near zero any longer. Game-set-match!

Frankly, the greater unknown in December is less what the Fed will do, but how **long term rates** will perform ***once*** the short term benchmark rate is increased. Will foreign demand for US Treasury notes and bonds remain so strong that longer term yields remain at around the current 2% level, or fall even further --- just when short term rates are moving higher? That is, could we see a narrowing of the spread between the two time frames? The last thing the Fed wants to see is a significant flattening of the yield curve next year, since that could discourage banks from lending, thereby slowing US economic growth and forcing the Fed to consider reversing course on interest rates sometime in 2016.

Once the fed funds rate moves up, the shape of the yield curve should be monitored closely in the months that follow.

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