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ECONOMIC TALKING POINTS

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A Few Observations About Today's FOMC Meeting And Press Conference ----And Then Some

The main takeaway:

The Fed deleted "patient" from their statement, noted some recent weakness in economic growth, signaled it was not going to raise rates in April, and will look for further improvement in labor markets before it starts to lift rates, which can possibly begin in June….then again, maybe not! That's the gist of today's events.

Now for some additional perspective:

We believe the FOMC statement and Yellen's comments at the press conference have heightened the probability for a June lift off.

We came to this view not just from the elimination of "patient," but from repeated comments during the press conference of how much labor market conditions have bounced back, especially in terms of the drop in the unemployment rate, declining slack among the unemployed and fewer people stuck with part time work.

Most intriguing and unique was the comment made in the statement and repeated at Yellen's press conference that the Fed will consider a rate increase if the FOMC *"is <u>reasonably confident</u> that inflation will move back to its 2 percent objective over the medium term."* (Our emphasis)

This suggests that, on balance, the main determinants on when the Fed's zero rate policy comes to an end will be based more on healthy job numbers and signs of wage growth --- and not necessarily once inflation shows concrete signs moving towards the 2% percent target.

We also detected from Yellen's comments that the Fed does not seem especially concerned about the recent slowdown in economic growth or low level of inflation. She hinted that both are the result of transitory factors (weather, subdued exports due to the strong dollar, and cheaper fuel prices). More meaningful evidence of the economy's vigor would come from the fast pace of hiring and other key labor market indicators.

Finally, Yellen appeared most animated during the Q&A when asked about the risks of waiting too long to raise rates. She spoke passionately of the dangers of falling behind the inflation curve, which adds to our belief that a June increase is likely so long as the job market stays on course --- ***even*** if inflation lags behind the target of 2%.

Yellen followed-up by noting that as slack in the labor force diminishes, it will inevitably push wages higher, a process that is already underway. Bigger paychecks at a time of dismal productivity growth will place pressure on the Fed to act sooner rather than later.

So, once again, we look to June as the probable month for the Fed to make its first move.

There were other related issues about the economy the last 24 hours that warrant further discussion.

1. Housing data

Yesterday's coverage of disappointing new home construction numbers veered all over the place.

There was wide disagreement among analysts whether the decline in housing starts last month should be attributed to bad weather, or evidence the economy was losing steam.

But a closer look at that data actually provides an answer. The historic cold weather and massive snowstorms across the Northeast and Midwest were in fact the main culprits.

Here are the key stats that shed better light on why housing starts plummeted by 17%, to an 897,000 rate in February.

First, when inclement weather sets in, it slows the progress on homes already under construction. Snow, ice and freezing temperatures halted or reduced work on residential construction sites across much of the country in February. So much so, that the cumulative impact of adverse weather conditions **caused the number of homes still incomplete (or "under construction")** to an 836,000 rate last month, the highest in more than 7 years! ***Simply put, builders will not break ground on new sites when they are still far behind schedule completing earlier homes.***

Not surprisingly, home completions last month fell to an 850,000 rate, compared with a monthly average of 928,000 the previous six months.

The Northeast and Midwest, which suffered the brunt of the storms, showed the largest declines in February, with starts down 56.5% and 37%, respectively for the month. Both regions accounted for nearly 45% of all home completions last year.

One bright spot in this report that suggested stronger home building activity in the future was the ratio of starts to permits. As long as the pace of permits exceeds actual starts, it tells us builders have some catching up to do. The February ratio of permits to starts was 1.22, compared with 1.04 for all of 2014.

Bottom line: new construction should rebound markedly this spring.

2. How worrisome is deflation in the US? There needs to be a distinction between good deflation and bad deflation.

Some Fed policymakers believe the danger of harmful deflation still exists and this justifies maintaining a highly accommodative monetary policy. But that view reflects a simplistic notion on the nature of deflation in the US at this time.

A distinction is needed between "good deflation" and "bad deflation." Good deflation occurs when prices slide as a result of a major technological breakthrough, one that leads to a supply shock, which in this case involves oil! The revolution in shale production and subsequent increase in crude output caused oil prices to plummet. That consequently slashed fuel bills for businesses and homes. In other words business and household costs went down, but overall demand in the economy was strong.

Bad deflation occurs when there is an absolute vacuum of demand. When consumption contracts, pricing power collapses. That is more typical of the problems faced in Europe and Japan these days, but not the US. Indeed, domestic demand for goods and services the last three quarters has been the strongest in more than a decade!

Chronic, destructive deflation is not simply possible in the US under current circumstances. It violates the laws of gravity. We've got good deflation, so enjoy it.

3. Let's not confuse normalizing interest rates with a tightening in monetary policy.

An end to the Fed's "zero interest rate policy (ZIRP)" is NOT the same as monetary tightening. Yet all too often we hear analysts refer to an interest rate increase this year as an act of tightening.

So let's be clear. So long as the fed funds rate remains below the level of inflation, it is inherently simulative. PCE inflation in the previous quarter was up an annualized 1.1%, with the core at 1.4%. The Fed's latest central tendency forecast show policymakers there expect headline inflation to rise between 0.6% to 0.8% this year, and for core to increase 1.3% to 1.4%. Yet their median projection sees fed funds climbing to 0.65% at the end of 2015. A rate hike that still leaves fed funds negative in real terms, or even marginally positively as may the case thru 2017, is not the same as "tightening," that is specifically designed to curb growth.

Federal Reserve's year-end forecasts of fed funds rate & PCE inflation, as of March 18, 2015

	2015	2016	2017
Fed funds	0.65%	1.625%	3.125%
PCE inflation	0.6% - 0.8%	1.7% - 1.9%	1.9% - 2.0%

All that's being done is to ***begin*** the process of normalizing rates to a neutral or equilibrium level where fed funds neither stimulates nor restrains economic activity. Ultimately this could mean moving the benchmark rate the next five years to its neutral level of about 3.50%.

However, the Fed DOES have one major risk before it. A rate increase could set the stage for a much flatter yield curve and that could be problematic for the economy. With rates across the maturity spectrum about the same, banks could issue fewer new loans (since shrinking net interest rate margins make such lending less profitable). Borrowers with adjustable rate loans also face higher debt service costs and fewer options to refinance. Both can be harmful.

To avoid such a predicament, the Fed should be prepared to scale back or end purchases of longer term securities to replace those maturing on its balance sheet. That should increase the supply of notes and bonds in the market, edge yields higher and produce a more a positively sloped yield curve. We're not there yet, of course. But once the Fed begins to lift rates, the shape of the yield curve bears close monitoring.

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