THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

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The Fed is Now Data Dependent on a Global Scale

The longest drum roll in central bank history will last for at least another month.

We doubted the Federal Reserve would choose to act in September. The recent thrashing in global stock markets, China's profound economic struggles, a looming debt crisis among emerging countries, concerns of a worldwide economic slowdown and, finally, the tremulous pleadings by the IMF, the World Bank and numerous foreign central banks, beseeching the Federal Reserve to hold off on raising rates was enough to convince most on the FOMC that a rate hike was just too risky at this time.

Yet, something significant has changed. By keeping the fed funds rate at the emergency level of near zero, the Yellen Fed is acknowledging that the US is now so closely integrated into the global economy, it can no longer focus on just domestic conditions. Indeed, this integration has apparently become so complete, the Fed could not in good conscience allow even for a miniscule 25 basis point increase --- despite the fact the US is close to full employment and with core PCE inflation more than half way toward the Fed's own 2% target

And so, for the first time since the 1990s, the FOMC statement explicitly pointed to foreign economic conditions as a primary factor in its decision not

to act this time. (FOMC statement: *"Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term."*)

Broadly speaking, the Federal Reserve decided to keep rates where they were after pondering four key issues.

1. Have the Fed's two key mandates been met?

The answer: Only partially.
They have achieved their mandate on the jobs front. At 5.1%, the jobless rate is the lowest in more than seven years. Labor market conditions are now very close to full employment.
Much less clear is whether the Fed has achieved its second mandate, which is to allow inflation to stabilize around 2%. July's core PCE rose 1.2% over the last 12 months. That may be a safe distance from outright deflation --- which the Fed wants to avoid at all costs --- but July's annual cost of living increase turned out to be the smallest of the year, and that is just not enough to comfort the Fed.
The result: hold off on a rate a rate increase.

2. How fragile are the U.S. financial markets?

The major US stock indexes appear to have regained their footing lately. But the violent market swings in recent weeks created such vertigo that many institutional and retail investors remain shaken by that experience. That jitteriness that could spill into the real economy and lead to cutbacks in US consumption and business capital spending.
The result: here's a second reason to hold off on a rate increase.

3. Are Fed policymakers confident in their forecast models?

Answer: No, why should they be? The Fed's mathematical models of the economy appear flawed. For years their forecasts have been too optimistic about growth, expected higher inflation sooner, and underestimated the speed with which the unemployment rate would decline. And if you now add to that problematic record the rapidly changing dynamics in the global economy and gyrations in the financial markets, it is hard to express much confidence in what these models say about the future. As economist Robert Heilbroner once said, mathematics has given economics rigor, but alas also mortis. That has never

been truer than today given boiling cauldron of economic, financial and geopolitical turbulence.

The result: a third reason to hold off on a rate increase.

4. Will a rate increase unleash new global FX worries and a trigger a debt crisis among emerging countries?

Answer: Very possibly. The worry is that if the Fed proceeds with its first round of monetary tightening in nine years, it would lead to a stampede of capital fleeing emerging countries and rushing to the safer and higher yielding shores of the US and Eurozone. But that would drive both the dollar and euro considerably higher in value, an unwelcome development for all concerned. Not only would this further hurt US and European exporters, it can also severely damage the financial health of companies in emerging economies who have to service some $3 trillion in dollar-denominated debt just when their export earnings are shrinking. An emerging country debt crisis could spread and trigger a wave of defaults across the globe, hurting creditors and destabilizing world financial markets once again.

The result: a fourth reason to hold off on a rate increase.

The obvious next question is this: Will international economic conditions sufficiently calm down to allow the Fed to finally lift rates at its October 27-28th meeting?

Possibly, though we tend to doubt it. From our perspective, the probability the Fed's marathon drum roll will finally end in December has jumped to 65%.

For if not then, does the Fed *really* want to begin a round of tightening in the middle of a politically charged presidential election year?

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