#43
Northern Exposure

key themes from the North Atlantic region

25 February 2015

Recent weeks have seen tension over the outlook for US monetary policy build amidst mixed signals. Equities are fully priced; volatility is low; and the labour market has a decidedly positive hue. Yet elsewhere there is reason for concern: retail sales have not (yet) received a boost from the low oil price; business investment and housing partials are soft; and inflation expectations have declined.

In its written communications, the FOMC had chosen not to provide specific guidance to participants, instead preferring to keep their options open, on both the timing of the first hike and the path that normalisation will take hence. This is an approach continued in Chair Yellen's semi-annual testimony.

It is apparent that the FOMC is very comfortable with the health of the labour market. Employment growth firmed through 2014 and was resilient in January; the unemployment rate has declined; long term unemployment has fallen *"substantially"*; and participants in the labour market are feeling more comfortable seeking new opportunities – the latter most apparent in the 'quits' rate rising back to near pre-recession levels, as referenced by Chair Yellen.

While the FOMC believes real GDP growth will not maintain the pace experienced through the second half of 2014 (3.75%), there is a belief that growth will remain strong enough to see continued improvement in the labour market, with a stronger pace of wages growth and a reduction in the underutilisation of workers (a rise in participation) being the key hoped-for outcomes.

The lower price of oil is seen as central to the expectation for continued, near-term robust economic growth and labour market improvement. It is very clear in Chair Yellen's comments, the January FOMC meeting minutes and anecdotes from Fed speakers that they all believe the decline in the price of oil will eventually stimulate discretionary consumption growth sufficiently to (at least) offset any decline in business investment in the oil sector as well as risks apparent across the globe.

Housing again received limited attention. All that was said was simply that *"activity remains well below levels we judge could be supported in the longer run by population growth and the likely rate of household formation"*. Ergo, as the labour market continues to firm, so will housing. Inherent here is a belief that term mortgage rates remain highly accommodative and that the effect of tight credit standards will lessen with time.

The inflation discussion provided by Chair Yellen was perhaps the most notable aspect of today's testimony. The impact of the price of oil was highlighted as a key factor behind the weakness in headline inflation. Second-round effects of the oil price decline and a *"decline in the prices of imported items"* were noted as potential causes of subdued core inflation – the latter a direct reference to the effect of the rise in the US dollar. Most importantly, both of these factors are interpreted to be transitory, and therefore not a concern for policy.

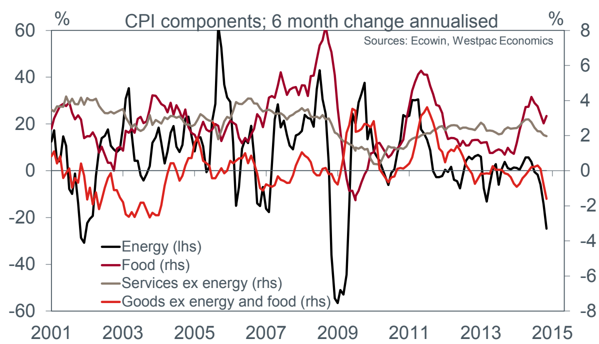
Of greater import for policy of late has been the marked decline in long-term inflation compensation, seen by some as evidence of an entrenched disinflationary trend. But in these remarks, Chair Yellen down played this concept, believing instead that this *"mainly reflects factors other than a reduction in longer-term inflation expectations"* (specifically, foreign growth and monetary policies in other countries). This then means that, as for growth and the labour market, there is a belief amongst FOMC members that inflation will firm towards the Fed's medium-term target as the economy continues to heal.

That then brings us to the likely timing of policy normalisation. The best characterisation is arguably soon, but not quite yet. In discussing the outlook for monetary policy, Chair Yellen was at pains to highlight that the removal of *"patient"* will not be an absolute signal for policy (seemingly preparing the market for a change at the March meeting). Rather, *"the modification should be understood as reflecting the Committee's judgment that conditions have improved to the point where it will soon be the case that a change in the target range could be warranted at any meeting"*. The decision to increase the Fed Funds rate will then be made on a *"meeting-by-meeting basis"*. Hence, no change in interest rates is guaranteed, in timing or scale; all actions will remain data dependent.

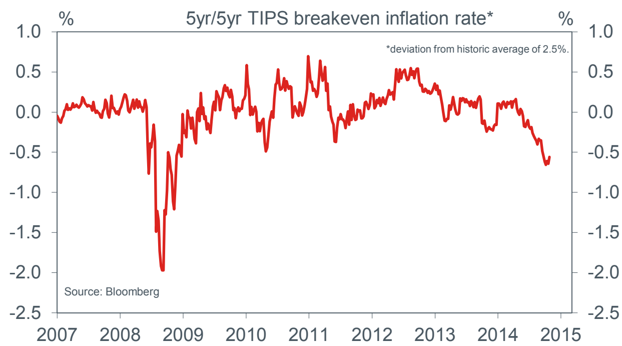
Overall, Chair Yellen's testimony leads us to believe that, while *"patient"* will be removed at the March meeting and that June is certainly live, September remains the most likely time for a first hike given the qualification around the labour market and the need for clearer evidence on the expected inflation profile.

By this time we will have seen further continued improvement in the labour market; the transitory effect of oil on inflation should have abated; and the FOMC will have been able to assess the impact of the recent rise in term interest rates on still-fragile segments of the economy, such as housing.

Petrol and USD having material impact on prices



Market inflation expectations have fallen sharply



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