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Something to Think About

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COMMON CENTS

This morning, I read an article about next week's FOMC (Federal Open Market Committee) meeting, and the importance of semantics. All eyes on Wall Street will be fixated on the Fed's statement after the meeting, and what it all means for future interest rate policy. The ensuing mental gymnastics will be as strenuous as executing a floor exercise wearing a 50 lb. weighted vest.

Not that I have ever done that, of course. I can barely do a somersault.

The easy money is on the Fed removing the word 'patient' in the middle of the third paragraph. Yes, we are slicing the meat that thinly these days. Here is the current verbiage, from the January statement:

> Based on its current assessment, the Committee judges that it can be **patient** in beginning to normalize the stance of monetary policy. However, if incoming information indicates faster progress toward the Committee's employment and inflation objectives than the Committee now expects, then increases in the target range for the federal funds rate are likely to occur sooner than currently anticipated. Conversely, if progress proves slower than expected, then increases in the target range are likely to occur later than currently anticipated.

Obviously, the Fed is being necessarily vague here. There is nothing in those sentences which can be construed as anything other than perhaps, maybe, or even a could be. On one hand, but, then again, on the other hand, regardless, we can be patient. Brother. Have we gotten to this? We have.

After all, it has been almost 9 years since the Fed last raised the overnight lending target between member banks, the so-called Fed Funds rate. That is a very long time. Shoot, it has been over 6 years since the Fed has cut the rate. This means, for the better part of a decade, I suppose you could argue the FOMC has gotten together once every 6 weeks, or so, to have coffee and donuts. Well, that and reword paragraphs like the one above.

You know, that is a crass oversimplification of things. The FOMC has also poured over reams of complicated analysis, diligently prepared by various staff economists, to come to the same conclusion: it doesn't have to be in a hurry to do anything different. It is all very academic, thought provoking, important, and all of that.

The funny thing is, I would be willing to bet you a plug nickel, if there really is such a thing, there ain't a single English major in the lot of them. Still, for as long as I can remember, the whole investment industry waits on pins & needles to see just how clever the FOMC has been with its choice of words.

So, what will go down next week? If the FOMC removes 'patient' from its statement, what will it use? How hard or soft will the word choice be? Hmm. Let me get out the Thesaurus. Wouldn't it be funny if it used the word fortitudinous? While I can look at the word to determine its meaning, I confess I was unfamiliar with it until about a minute ago. Maybe I learned it 'back in the day,' but who knows?

In the article I read, Mohamed A. El-Erian speculates:

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Good words are worth much, and cost little.

George Herbert

Something to Think About Cont.

> To this end, Fed officials will likely tweak their forward-policy guidance next week – most probably by removing the word "patient," which was inserted last December to replace the phrase "considerable time" in describing how the Fed plans "to normalize the stance of monetary policy."
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> The central bank then would be embarking on the next stage in a delicate balancing act. On the one hand, it would open the possibility of initiating a very gradual rate hike cycle starting this summer, possibly as early as June. On the other hand, it would wish to prevent markets from jumping the gun by immediately pricing in the higher interest rate that is likely to prevail at the end of the hiking cycle (the so-called terminal rate).
>
> In seeking to persuade markets to focus on what is likely to be a very slow and measured journey (instead of rushing to the ultimate destination, as has been historically the case), the Fed's "linguistic gymnastics" would evolve beyond just the removal of the "patient" language. Officials are likely to also stress the conditionality of its interest rate policy intentions, including the central bank's considerable willingness to alter course if economic prospects were to weaken.

Gang, that is why Mohamed gets the big bucks. Isn't that impressive, even though I am not exactly certain what his conclusion is? What will it be, Mohamed? Will the FOMC use cautious, deliberate, or reasoned instead? Or will it be a complete departure from the norm? Something along the lines of: "To this end, based on current market conditions, the Committee anticipates raising the overnight lending target between Fed member banks by 0.25% at the September meeting. Should economic conditions weaken in the interim, the Committee will leave current monetary policy in place until further notice. However, it will let the markets know, in no uncertain terms, what the next monetary policy change will be and when. So quit outthinking yourselves."

Wouldn't that be great? However, a lot of people would be without, as Dickens might has written, 'a situation' if the Fed suddenly stopped obfuscating things?

Make no mistake about it: all the volatility we have had this month, particularly the unpleasantness this week, is all about the previous use of the word 'patient' in the 3rd paragraph of the FOMC statement, and speculation over what word, if any, the Committee will use in its statement next week. Will a 'soft' word choice suggest the Fed will wait until September, or beyond, in order to start tightening credit? Will a 'hard' word choice or phrase mean the Fed is going to start in June and/or be more aggressive than originally anticipated?

I will go out on a very short limb, and say the Fed governors are not stupid people. Sure, I might make fun of how they drink coffee and eat donuts at these FOMC meetings; however, there is a lot of brain power in the room. So much so, I would be absolutely bamboozled if at least one person around the table hasn't noticed the financial markets have already done a lot of the FOMC's work.

After all, the dollar has rallied like crazy relative to other major currencies, which will keep consumer inflation in check as imports become less expensive as a result. Long-term interest rates have fallen significantly since this time last year, as inflation expectations have dissipated. To that end, the spread between the 10-year TIP (Treasury Inflation Protected security) and the current 10-Year Treasury Note is currently right at 1.7%. This means investors believe the

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Something to Think About Cont.

annualized rate of inflation will be 1.7% over the next decade. The expectations are basically the same for 30 years. Why is that important? Well, because the Fed has stated its long-term aim is to keep inflation at 2%. Voila. The CPI is currently less than that, and everyone expects inflation over the long haul will be as well.

Then we have to take a look at the Fed's employment mandate. How does that look? Granted, the Unemployment Rate has fallen dramatically, and the economy has added a pretty impressive number of jobs over the last 12 months. In truth, this might be the one area where there IS some justification for raising interest rates. However, you have to keep in mind, the Labor Force Participation rate is 62.8%, which is low compared to the 20-year average of 65.8%. While that might not sound like a lot, keep in mind 3.0% of the number the BLS uses to calculate this is about 7.5 million jobs. THAT is a lot.

Further, wage inflation is virtually non-existent. The BLS estimates the inflation-adjusted "usually weekly earnings of wage & salary earners" during 4Q 2014 was almost identical to what it was in 4Q 2004. In other words, the purchasing power of the average American worker hasn't done anything over the last decade. More than any of the other metrics, this would suggest the US labor markets aren't significantly tight. IF they were, the average American worker would be able to command higher wages than they currently can.

So, where the rubber meets the road, I fail to see the imminent inflationary pressures which would, or could, force the Federal Reserve to premature and/or aggressive in adopting a more restrictive monetary policy. Sure, the potential is out there, as central banks across the globe are, and have been, heck bent on devaluing their fiat currencies (which is kind of comical in and of itself) in order to stimulate economic growth, including the Fed. However, at this time, I think it would be more prudent for the Fed to be reactive to inflation, as opposed to proactive.

Don't get me wrong. I am certainly not advocating printing more money or anything along those lines. I am also not suggesting the Fed not ever doing anything. The worst has past, and the United States needs to eventually normalize its monetary policy, and that means raise interest rates at some point. Hey, I am all for that, but not if it means we run the risk of squashing a mediocre economy in the process. Would a 0.25-0.50% interest rate increase actually do that? You know, if it did, the US economy was going to have problems anyhow.

But why run the risk if the supporting data isn't absolutely demanding it? Why throttle an inflation bogey that exists in complicated mathematical equations and extrapolations, as opposed to what American consumers and businesses see at the store, at the pump, or in the income statement? I understand the threat of inflation will always be with us, as paper currencies around the world are intrinsically worthless; so 'we' need to be vigilant. However, I also understand I can't seem to find any major inflation gauge which suggests the need to do anything drastic or rash, or even anything for that matter.

Which is what makes this worrying about Fed semantics that much more frustrating to me. We all know the next Fed move will be a rate hike, period. We also all know there really isn't any reason for the Fed to be overly aggressive, and by that meaning raising rates more than 1.00% by the end of the year. People who have been doing this long enough also know it takes some time for Fed policy moves to completely filter through the economy. Finally, we all know a few well-telegraphed and orchestrated small rate increases shouldn't be crippling to the US economy...that is IF they are truly needed, which, as you can probably tell, I am not completely certain they are.

Frustratingly, we are hinging on word choice here, to speculate whether the Fed starts raising rates 0.25% in June, July, or in September. Word choice from an individual, Janet Yellen, who has degrees in Economics, and not English or Journalism, etc.

...so, Dr. Yellen, please choose your words carefully next week, and be smart. There is absolutely no reason to force a market drop or short-term economic swoon simply because you and the other Fed governors chose not to use a Thesaurus. Me? I like the word deliberate. It is strong than 'patient,' but still soft enough to put the worrywarts' minds at ease.