

Q3 2011

## Tracking The Fed – Signposts For A Shift In Monetary Policy

For nearly three years, the Fed has maintained a near zero target for the federal funds rate. The accompanying statements from the Federal Open Market Committee (FOMC) meetings justified this stance by indicating that expected “*economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations,*” warranted a low level in the federal funds rate.

These economic conditions provide signposts that will eventually point to a change in monetary policy. There are several economic indicators and market-based gauges that encompass signposts we can monitor as we look for indications of a turning point in monetary policy.

- **Resource Utilization** – Capacity utilization, unemployment rate, output gap
- **Inflation Trends** – Various inflation measures (PCE, CPI, PPI)
- **Inflation Expectations** – Market-based measures (Nominal vs. TIPS, inflation swaps) or survey-based measures (household expectations, Philly Fed Survey of Professional Forecasters)

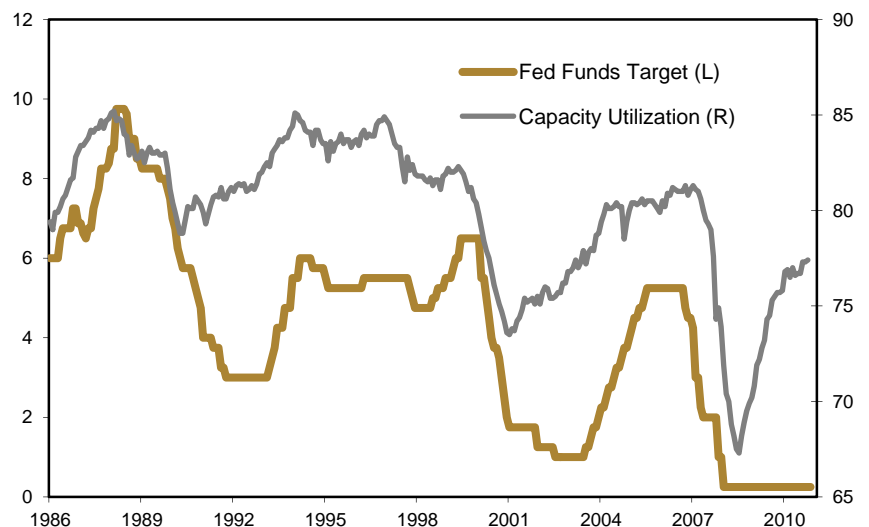
At the August FOMC meeting, the accompanying statement indicated that these economic conditions would persist long enough that the federal funds rate would remain exceptionally low “at least through mid-2013.” As illustrated below, the most recent signposts reinforce the FOMC’s position that the federal

funds rate will remain on hold.

After peaking in April, short-term inflation expectations declined, but remain at lofty levels due in large part to elevated commodity prices. However, long-run inflation expectations remain well anchored. Current levels of inflation have risen, but remain well below the Fed’s unofficial target range of 1.5% to 2.0% for core inflation. Utilization rates stabilized earlier in the year, but have been inching up over the last couple of months. Unfortunately, they remain well below levels that would trigger a response from the Fed.

### Resource Utilization

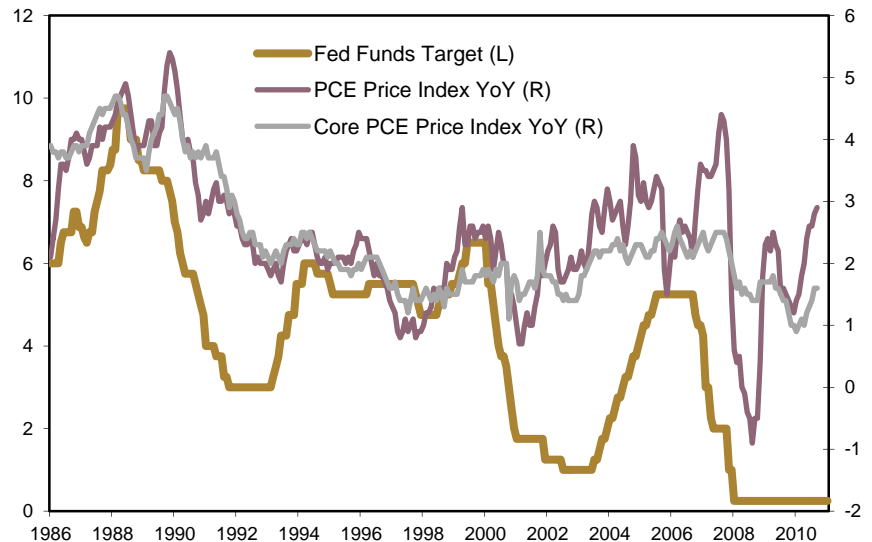
- Capacity utilization is one measure of slack in the manufacturing sector.
- The long run average for this metric is approximately 81% with the markets typically looking for a pickup in inflation when this measure surpasses 83%.
- However, a long-run analysis of this series shows that the trend has been declining since the mid-1970’s. This indicates that the threshold for inflationary pressures may actually be lower than 83%.
- After stagnating during the first half of the year, capacity utilization rates are once again on the rise. Although well below a Fed trigger point, capacity utilization reached 77.4% in September. Unfortunately, other measures of resource utilization such as the unemployment rate have not improved.



Source: Bloomberg, Federal Reserve

## Inflation Trends

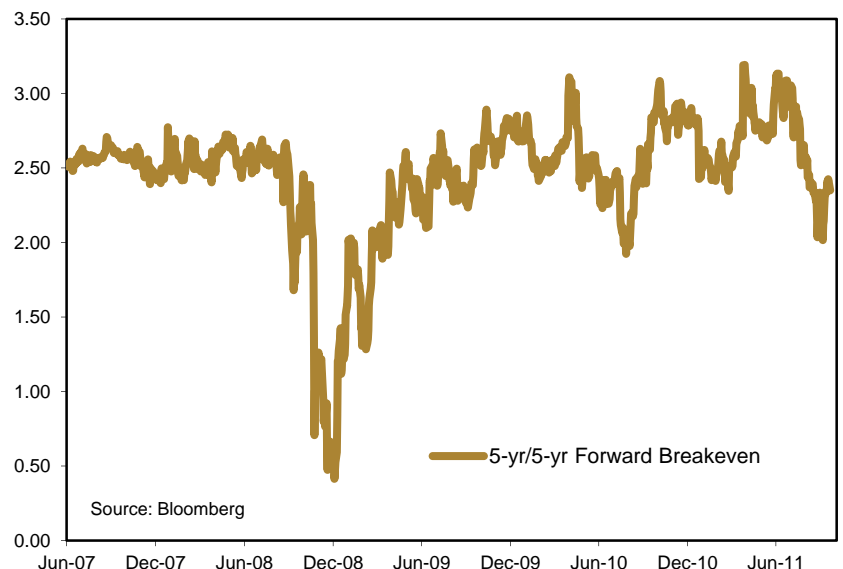
- As mentioned above, there are several measures of inflation at various stages of the pipeline.
- The FOMC adopted the Personal Consumption Expenditure (PCE) Deflator as its preferred measure of consumer prices.
- With commodity prices well below the peak figures seen in April of this year, inflation figures are expected to begin leveling off at current levels.
- After moving sharply higher through July, core PCE held steady at 1.6% in August. This figure is at the top of the Fed's central tendency range of 1.3% to 1.6% for core PCE as established at the June FOMC meeting.



Source: Bloomberg, Federal Reserve

## Inflation Expectations

- There are many gauges of inflation expectations, but finding one that provides an accurate assessment of the future path of inflation is difficult.
- The market based 5-yr/5-yr Forward Breakeven has become a popular measure of inflation expectations; however, the volatility in the series has raised some questions.
- The high volatility indicates that the market may be pricing in more than just inflation expectations and may be actually including risk premia.
- Long-run inflation expectations, as measured by the 5-yr/5-yr Forward Breakeven, are actually lower than they were at the end of 3Q2010. Other short-run inflation expectations, such as those measured by consumer surveys, continue to indicate that consumers expect inflation to rise more than breakeven levels imply. However, these figures have been grinding lower as prices at the pump have fallen during the quarter.



Source: Bloomberg, Federal Reserve

## Learn More

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