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Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com

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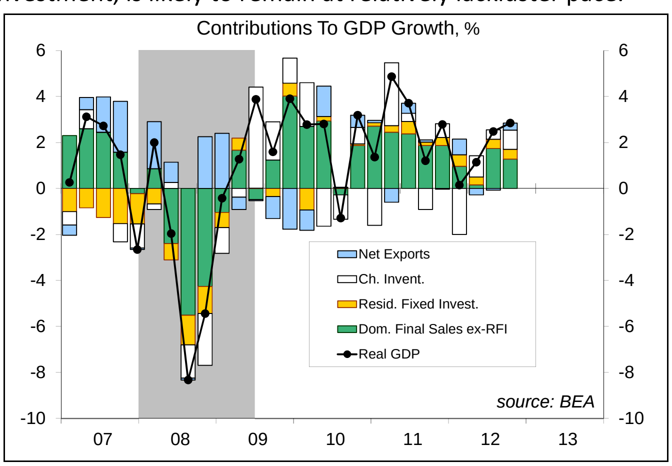
Monthly Economic Outlook

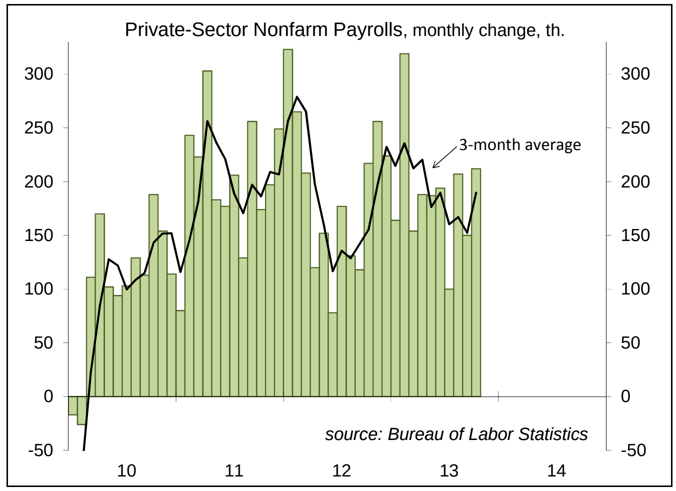
Fed Policy – Boxed In, But For How Long?

- *Minutes of the October 29-30 Federal Open Market Committee showed that officials expected to taper "in coming months," but there was disagreement about when and how the Fed would communicate its intentions.*
- *The rise in long-term interest rates, if due to a misinterpretation of the Fed's intentions, is unwelcome. The commitment to keep short-term interest rates low should prevent long-term interest rates from rising too rapidly.*
- *The change in Fed leadership should be seamless. Janet Yellen has had a strong hand in the Fed's policies. However, the Fed will face a number of challenges as it begins to normalize.*

Real GDP rose at a 2.8% annual rate in the third quarter, better than anticipated. However, the advance estimate was boosted by a narrower trade deficit and faster growth in inventories (recall that *the change* in inventories contributes to the *level* of GDP, hence *the change in the change* in inventories contributes to GDP *growth*). Recent data suggest that the trade deficit likely widened rather than narrowed (as was assumed in the advance GDP estimate), while inventories rose at a faster pace than was assumed in the advance estimate. While the GDP estimate will be revised, growth in the key components, consumer spending and business fixed investment, is likely to remain at relatively lackluster pace.



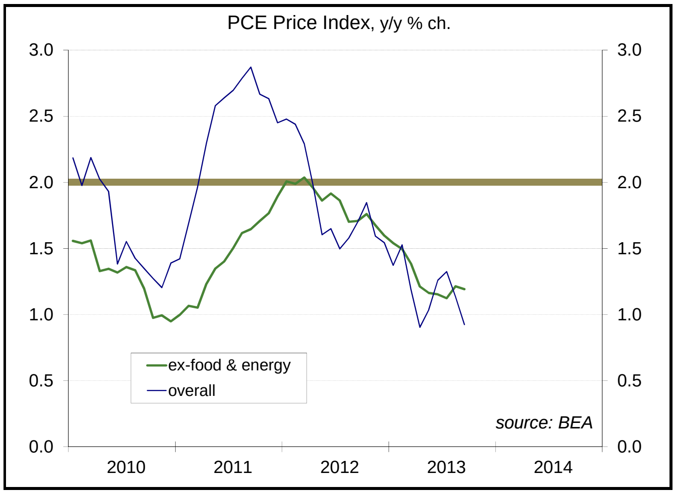
The partial government shutdown did not have a significant impact on the nonfarm payroll figures for October, but did distort the household survey data. Payrolls rose more than expected last month, with upward revisions to both August and September. Private-sector payrolls averaged a 202,000 monthly gain over the last three months and 196,000 (+2.1%) over the last year. That's more than what's needed to be consistent with the growth in the working-age population. Employment gains in state and local government appear to be offsetting job cuts at the federal level.



The Fed began its current asset purchase program a year ago, with the goal of *"substantial improvement"* in labor market conditions. The job market has improved significantly over the last year, but has that been enough? The amount of slack remains considerable. Long-term unemployment remains a serious problem and measures of underemployment are still very high. Still, the asset purchase program cannot last forever. Chairman Bernanke has suggested that QE3 was meant to be *"a booster rocket,"* which would be jettisoned once the economic recovery achieved sufficient momentum. The Fed would continue to add policy accommodation as it slows the rate of asset purchases and will continue to rely on its forward guidance on short-term interest rates to provide support.

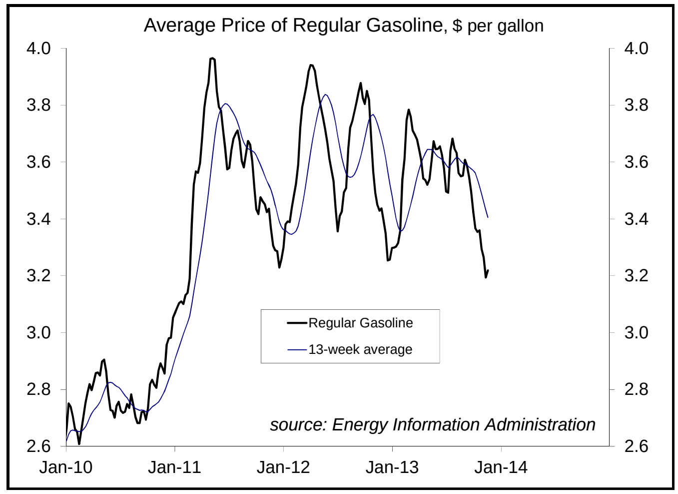
However, the Fed's decision to taper has been complicated by a number of factors. Most notably, long-term interest rates moved higher in the spring and summer. Such an increase is not necessarily bad if it reflects an improved economic outlook or an unwinding of excessive financial leverage. However, an increase in long-term interest rates due to expectations of tighter monetary policy is *"neither welcome nor warranted,"* according to Bernanke. Market participants generally expected the Fed to begin tapering at the September policy meeting, but officials decided to delay, citing concerns about the impact of tighter financial conditions, policy uncertainty in Washington, and a low trend in inflation. Minutes of the October 29-30 policy meeting showed that officials expected the economy to improve in line with previous projections which *"would thus warrant trimming the pace of purchases in coming months."* Fed officials also considered scenarios where the Fed could begin to taper *"before an unambiguous further improvement in the outlook was apparent"* and debated how best to communicate its intentions with the public. There was little support for reducing the 6.5% unemployment rate threshold on its forward guidance (as had been speculated).

While some investors have feared that the Fed's policies would lead to a substantial increase in inflation, the PCE Price Index, the Fed's chief inflation gauge, has trended at a low level. Well-anchored inflation expectations make the Fed less fearful about deflation, but the low inflation trend is a concern.



Fed officials are likely to emphasize the forward guidance as asset purchases are scaled back. Other central banks have adopted some form of commitment to low short-term interest rates. There are two flavors of forward guidance: Odyssean and Delphic. The Delphic (after the Oracle of Delphi) would commit to low rates based on the economic outlook. The Odyssean (after Homer's *Odyssey*) would commit to low rates for a specific period – no matter what the data (Odysseus, also known by the Roman name Ulysses, had himself bound to the mast to resist the sirens' call). Research suggests that Odyssean forward guidance would be much more effective than the Delphic variety. The Fed is almost certain to continue with the Delphic approach, which may seem more "Sisyphean."

The transition in Fed leadership should be uneventful. Janet Yellen is extremely qualified to lead the Fed. Policies are likely to be essentially the same as they would have been under Bernanke. Like Bernanke, Yellen is willing to listen to other points of view and policy will continue to be formed by consensus. However, as the Fed's struggle with how to begin tapering demonstrates, there will be many hurdles ahead.



Average weekly wages adjusted for inflation have trended poorly in recent years. The typical worker is running fast just to stay in place. Consumer spending growth in recent years has been driven largely by job growth. However, lower gasoline prices could help boost purchasing power into the new year.

Fiscal policy was the major economic headwind in 2013. The government's current spending authority will end in mid-January and the borrowing authority expires on February 7. Lawmakers are unlikely to agree to a grand bargain on the deficit, but they should be able to agree to kick the can down the road. Mid-January sequester cuts will be a modest drag.

	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	2012	2013	2014	2015
GDP (↓ *contributions*)	0.1	1.1	2.5	2.8	1.6	2.4	2.7	3.0	3.0	2.8	1.7	2.5	3.0
consumer durables	0.7	0.4	0.5	0.6	0.2	0.3	0.3	0.3	0.3	0.5	0.5	0.3	0.3
nondurables & services	0.4	1.1	0.8	0.5	1.3	1.3	1.4	1.5	1.5	1.0	0.8	1.2	1.5
bus. fixed investment	1.1	-0.6	0.6	0.2	0.4	0.5	0.6	0.7	0.7	0.8	0.3	0.5	0.7
residential investment	0.5	0.3	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.3
government	-1.3	-0.8	-0.1	0.0	-0.1	-0.1	0.0	0.1	0.1	-0.2	-0.4	0.0	0.1
Domestic Final Sales	1.4	0.5	2.1	1.7	2.2	2.4	2.6	2.8	2.9	2.5	1.5	2.4	2.9
exports	0.2	-0.2	1.0	0.6	0.4	0.5	0.6	0.6	0.6	0.5	0.3	0.6	0.6
imports	0.5	-0.1	-1.1	-0.3	-0.2	-0.4	-0.5	-0.5	-0.6	-0.4	-0.2	-0.4	-0.6
Final Sales	2.2	0.2	2.1	2.0	2.4	2.5	2.7	2.9	3.0	2.4	1.5	2.3	2.9
ch. in bus. inventories	-2.0	0.9	0.4	0.8	-0.8	-0.1	0.0	0.0	0.0	0.2	0.0	0.0	0.0
Unemployment, %	7.8	7.7	7.5	7.3	7.2	7.1	7.0	6.8	6.7	8.1	7.5	6.9	6.4
NF Payrolls, monthly, th.	209	207	182	163	180	185	195	200	210	183	183	198	196
Cons. Price Index (q/q)	2.2	1.4	0.0	2.6	1.8	1.9	1.9	1.9	2.0	2.1	1.5	1.9	2.0
excl. food & energy	1.7	2.1	1.4	1.8	1.7	1.8	1.8	1.8	1.9	2.1	1.8	1.7	1.9
PCE Price Index (q/q)	1.6	1.1	-0.1	1.9	1.8	1.8	1.8	1.8	1.9	1.8	1.2	1.6	1.9
excl. food & energy	1.3	1.4	0.6	1.4	1.6	1.7	1.7	1.7	1.7	1.8	1.3	1.5	1.7
Fed Funds Rate, %	0.16	0.14	0.12	0.09	0.10	0.12	0.16	0.20	0.22	0.14	0.11	0.18	0.93
3-month T-Bill, (bond-eq.)	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.9
2-year Treasury Note	0.3	0.3	0.3	0.4	0.3	0.4	0.6	0.8	1.0	0.3	0.3	0.7	1.6
10-year Treasury Note	1.7	2.0	2.0	2.7	2.7	2.9	3.0	3.1	3.4	1.8	2.3	3.1	4.1