Weekly Economic Commentary

December 15, 2014

Potential Outcomes of the Final FOMC Meeting of 2014

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Highlights

Statements following the final FOMC meeting of 2014, particularly on the recent drop in oil prices and its impact on the U.S. economy, could have ramifications for near- and long-term monetary policy.

The FOMC will also provide markets with a new set of targets at this meeting, as it does four times a year. Market participants will be eager to compare the new FOMC forecast with the last one from September 2014.

There is precedence for the Fed chair to hold a public discussion on oil prices, which could indicate if the Fed shares any of the market's concerns about the speed of the decline in prices over recent months

With quantitative easing (QE) over, financial market participants are now focused intently on the timing of the first Fed rate hike.

The policymaking arm of the Federal Reserve (Fed), the Federal Open Market Committee (FOMC), will hold its eighth and final meeting of the year this week (December 16–17, 2014) amid a near historic collapse in oil prices. What the FOMC says, if anything, about the drop in oil prices—and its implications for the U.S. economy, labor market, and inflation—could have ramifications for monetary policy over the next several quarters and beyond.

Watching the Language of the FOMC Statement

On Wednesday, December 17, 2014, at the conclusion of the two-day meeting, the FOMC will release a statement as well as a new economic and interest rate forecast. In addition, Fed Chair Janet Yellen will conduct her fourth and final post-FOMC meeting press conference of the year. With quantitative easing (QE) over—the FOMC made its final purchases of mortgage-backed securities (MBS) and Treasuries in October 2014—financial market participants are now focused intently on the timing of the first Fed rate hike. Currently, financial market participants expect the first Fed rate hike to occur in the final months of 2015, but that view may change if the Fed alters its promise to keep rates low for "a considerable time" after the end of QE.

This promise, which is commonly known as "forward guidance" among Fed watchers and financial market participants, has been a part of every FOMC statement since September 2012. Removal of the "considerable time" language without replacing it with other, similar, language would likely be viewed by market participants as a sign that the Fed was getting ready to raise rates by mid-year 2015 or earlier, well ahead of what the market is currently pricing in.

If the FOMC does remove "considerable time" from the statement, it may choose to replace that phrase with the word "patient," or similar words, which was used extensively in the run-up to the first rate hike of the 2004–2006 rate hike cycle. We also continue to expect the FOMC to tie the first rate hike to the performance of the economy, in particular, the labor market and inflation. Fed officials refer to this concept as "data dependence." Words like "patient" have been used quite frequently in public appearances (speeches and interviews) by FOMC members in recent months, and may be used as transition words in the FOMC statement for the next few meetings until it becomes clear to FOMC members that the overall economy, the labor market, and inflation are well on their way toward hitting the FOMC's targets.

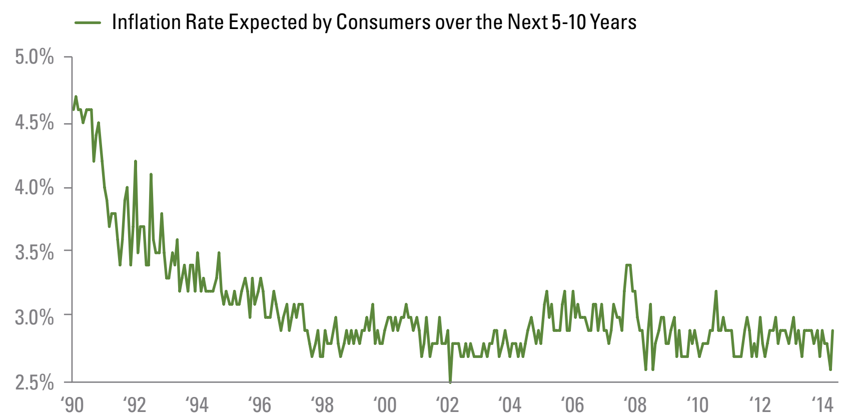
The FOMC will also provide markets with a new set of targets at this meeting, as it does four times a year. The FOMC's new forecast for gross domestic product (GDP), the unemployment rate, inflation, the appropriate timing of the first rate hike, and the so-called "dot plot" (the appropriate level for the fed funds rate at year end in 2015, 2016, 2017, and beyond) will be scoured by market participants looking for clues as to how the FOMC's own economic forecast has evolved since the last FOMC forecast was released in September 2014.

What Will the Fed Say About Oil Prices?

In the past, the Fed has viewed increases in oil prices as a drag on growth more than a boost to core inflation and is likely to view the recent drop in prices through the same prism.

Fed Chair Yellen is almost certain to mention data dependency and patience in removing stimulus—along with financial conditions—in her post-FOMC press conference and is almost certain to be asked about the recent drop in oil prices as well. In the past, the Fed has viewed increases in oil prices as a drag on growth more than a boost to core inflation and is likely to view the recent drop in prices through the same prism: i.e., the drop in prices should be a boost for the economy and should have only a transitory impact on core inflation. The drop in oil prices is also likely to warrant a mention in the FOMC statement as it relates to inflation expectations [Figure 1]. Our concern—and the market's—is around the speed of the decline in oil prices, and that could also be a topic covered by Yellen at her press conference.

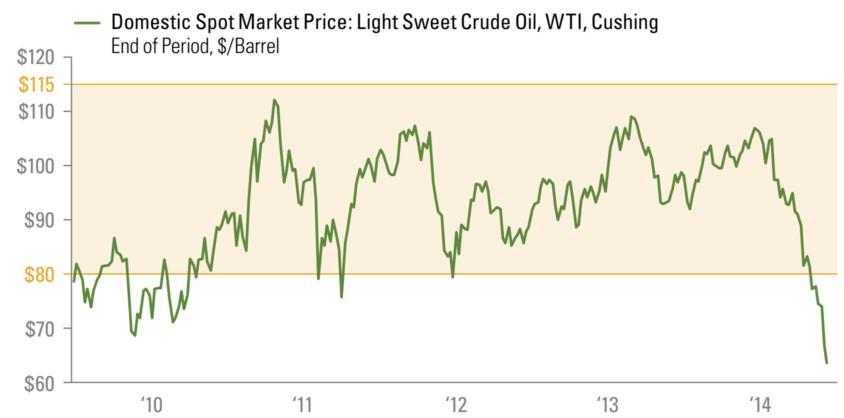
1 The Fed Is Monitoring Consumers' Inflation Expectations Closely



Source: LPL Financial Research, University of Michigan 12/15/14

There is recent precedent for the Fed chair to have a lengthy public discussion of oil prices, and it happened to occur right after the onset of the Arab Spring in 2011. The Fed's first post-FOMC press conference was held by Fed Chairman Ben Bernanke on April 27, 2011. At that time, oil and gasoline prices were surging as a result of the Arab Spring, which began in Tunisia and Algeria in January 2011, driving oil prices from around $80 per barrel at the end of September 2010 to near $115 per barrel in late April 2011, a 40%+ increase in a little over six months [Figure 2]. During that press conference, Bernanke discussed the negative effects of rising gasoline prices on the economy, consumer spending, inflation, and inflation expectations. Fed Chair Yellen could address some similar topics this week, although she faces the opposite scenario.

2 Until the End of October 2014, Oil Has Traded Between $80 and $115 Since Mid-2010



Source: LPL Financial Research, Energy Information Administration, Chicago Mercantile Exchange, Haver Analytics 12/15/14

Oil prices hit their peak for this economic recovery at just over $114 per barrel just two days after Bernanke's press conference in April 2011. From that point until late October 2014, oil traded in a range between $80 and $115. Today, oil stands at just under $60 per barrel, nearly 50% below the peak set in late April 2011. While the positives of lower oil prices for the U.S. economy outweigh the negatives, the speed of the decline in prices over recent months has raised concern among financial market participants about the financial market implications of lower oil prices, and those concerns may also be shared by the Fed. We will all find out on Wednesday, December 17, 2014. ■

RES 4925 1214
Tracking #1-336692 (Exp. 12/15)