In his press briefing following the June 19 FOMC meeting, Fed Chairman Bernanke outlined how the evolution of the economic outlook will drive policy decisions in the months ahead. The key messages are that monetary policy will remain data-dependent, that tapering is not tightening, and that higher short-term interest rates are still a long way off. The markets have focused on the expected timing of the step down in asset purchases, but whether that happens a few months earlier or later shouldn’t really matter. Either the markets are misinterpreting what Bernanke said or the markets were badly mispriced to begin with.

Bernanke said that if the economic outlook proceeds as anticipated (growth picks up, unemployment declines, and inflation moves gradually back to the 2% target), then the Fed would likely step down the pace of asset purchases later this year, and if the economy remains on the expected recovery path, the Fed will likely end the asset purchase program in mid-2014 (as the unemployment rate reaches 7.0%). In no way is this written in stone. Policy decisions will depend on whether the outlook for growth is stronger or weaker than anticipated – and the outlook will almost certainly deviate from that path.

In their updated economic projections, Fed officials raised their outlooks for 2014 GDP growth slightly (to 3.0-3.5%, from 2.9-3.4%) and lowered their expectations for 4Q14 unemployment (to 6.5-6.8%, from 6.7-7.0%). Note that the Fed has consistently overestimated GDP growth in recent years:

The Fed’s belief that economic conditions may warrant a reduction in the pace of asset purchases later this year doesn’t mean that the Fed will do so. Bernanke emphasized (in his opening statement and a number of times in the Q&A) that “our policy is in no way predetermined and will depend on the incoming data and the evolution of the outlook, as well as on the cumulative progress toward our objectives.”

It’s also important to remember that a reduction in the rate of asset purchases is not a tightening of monetary policy. The Fed would still be expanding its balance sheet and adding accommodation. Bernanke used the analogy of driving a car. In reducing the rate of asset purchases, the Fed would be slightly taking the foot off the gas pedal. It would not begin hitting the brakes (raising the federal funds rate target) for some time.

Investors have often confused the Fed’s stated quantitative thresholds for its forward guidance on the federal funds rate (6.5% unemployment, a one- to two-year inflation outlook of 2.5%) with the qualitative threshold on the asset purchase program (“substantial improvement” in job market conditions). Bernanke noted that “the current level of the federal funds rate target is likely to remain appropriate for a considerable period after asset purchases are concluded.” The 6.5% unemployment rate is a guidepost, not a trigger, for higher short-term rates. He suggested that, along with other factors, unemployment coming down to 7% would constitute “substantial improvement.”
Bernanke indicated that Fed officials were “a little puzzled” by the market reaction to the rise in long-term interest rates heading into the Fed policy meeting. After all, it’s the total amount of assets purchased that matters – not the monthly pace. Whether the Fed begins to reduce the rate of asset purchases a little earlier or later doesn’t have much of an impact on total purchases, and therefore shouldn’t have much impact on long-term interest rates. Fed officials concluded that there must be other factors lifting long-term interest rates, such as increased optimism about the economy.

Bernanke seemed surprisingly complacent about whether higher long-term interest rates would impede the recovery, particularly the housing sector. The reason behind the increase in long-term interest rates is important. If they’re rising due to an improved economic outlook, “that’s a good thing,” said Bernanke. He also noted that rising home prices and increased confidence in the housing sector could offset any negative impact from higher mortgage rates. Note that in the June survey of homebuilder sentiment, no builders mentioned the recent rise in mortgage rates.

Bernanke also seemed complacent about low inflation. The FOMC statement noted a formal policy dissent by St. Louis Fed President Bullard, who felt that FOMC “should signal more strongly its willingness to defend its inflation goal. The FOMC sees the recent low inflation trend as due to “transitory factors.”

Under Bernanke’s leadership, Fed communications have become much clearer, but oddly, not for the markets. Maybe the Fed should go back to a veil of vague language. Or perhaps Bernanke can start sending out Tweets in Latin. Quid nobis infeliciter fieri potest? (What could possibly go wrong?)

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