

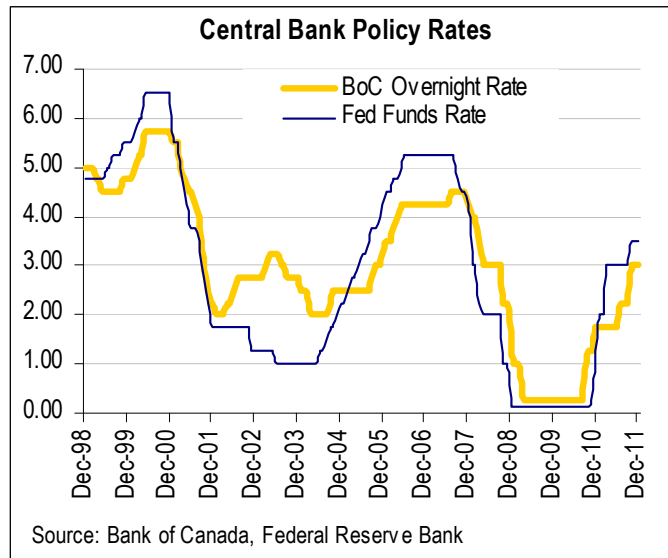


January 28, 2010

FOMC Meeting: No Change... But Some Evolution!

As widely anticipated, the U.S. Federal Reserve left its policy rate **unchanged** at 0-to-0.25% at the conclusion of its two-day policy meeting on January 27th. There were some relatively minor adjustments on the economic growth and inflation commentary, as well as some further detail on the withdrawal of last year's emergency liquidity facilities.

Nevertheless, the key commitment to keep the policy rate at "*exceptionally low levels [...] for an extended period*" was maintained, although this time one Fed official (Thomas Hoenig) voted against it judging that financial conditions had changed sufficiently to warrant an end to it. While this dissention is possibly a necessary first step towards an eventual normalization of policy rates, the **fact of the matter is that the Fed is still very far from actually doing anything in that respect.**



The stark reality is that household spending, the key ingredient in any sustainable economic recovery, remains "... constrained by a weak labour market, modest income growth, lower housing wealth and tight credit." And this reality is not expected to improve significantly any time soon. To this list of headwinds, I would add fiscal credibility and operational uncertainty regarding the exit from quantitative easing by the Federal Reserve itself.

In this context, it is important to note that the Fed also maintained its commitment to bring to an end by March its purchases of agency mortgage-backed securities (\$1.25 trillion). Citing improved financial markets, the Federal Reserve will also be closing over the next few months the numerous special liquidity facilities put in place in 2008-09.

The bottom line is that the Federal Reserve is not any closer to raising policy rates; we still expect a first move

to take place only in Q4-2010, at the earliest. In the meantime, all the special quantitative easing measures put in place over the past 18 months or so will be gradually wound-down. Economic growth is still fragile and we continue to have serious doubts about the "staying power" of the recovery. Real GDP growth in Q4-2009 and into Q1-2010 will indeed come in the 4-to-5 percent range but that reflects primarily increased public spending and a powerful inventory cycle. Final private domestic demand remains weak for all the reasons highlighted above, especially the distressed labour market. We continue to believe it is next to impossible for the Federal Reserve to start raising policy rates before the rate of unemployment has clearly peaked, and that is unlikely to happen before Q3-2010. In the next six months or so, the key uncertainty regarding monetary policy is not so much the timing of policy rate increases but rather the withdrawal of quantitative easing measures and market reaction to those changes. For example, once the \$1.25 trillion program of purchases of mortgage-backed securities expires on March 30th, it is not immediately clear what happens to bond yields and, ultimately, residential mortgage rates and the (fragile!) housing market. Our year-end forecasts for the fed funds target rate are 1.75% in 2010 and 3.50% in 2011.

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