Fed Unshaken by Global Market Turmoil Bets on Job Gains

By Craig Torres - Oct 30, 2014

Federal Reserve officials dismissed recent turmoil in global financial markets, and focused instead on “solid” employment gains that will keep them on a path toward an interest-rate increase next year.

A majority of U.S. policy makers at their meeting yesterday also set aside concerns, both among their own members and in financial markets, about too-low inflation, voting to proceed with plans to end their third round of asset purchases.

“The FOMC is making a pretty bold call here,” said Chris Rupkey, chief financial economist at Bank of Tokyo-Mitsubishi UFJ Ltd. in New York. “The economy's momentum is strong enough to push through the headwinds of slower world growth.”

While bond and commodities markets have signaled concern about a global slowdown since Fed officials last met Sept. 16-17, U.S. central bankers decided to go with the facts in hand, said Paul Mortimer-Lee, chief economist for North America at BNP Paribas in New York.

“They have concentrated on what they are sure of: the labor side of the economy is improving,” Mortimer-Lee said. On inflation, the message was, “We are going to take our time and look.”

The Federal Open Market Committee maintained its commitment to keep interest rates low for a “considerable time.”

The committee cited “solid job gains and a lower unemployment rate” since its last gathering in September. It said “underutilization of labor resources is gradually diminishing,” modifying earlier language that referred to “significant underutilization.”

Payroll Gains

Non-farm payroll gains have averaged 227,000 this year, heading for the best showing since 1999. That has helped push the unemployment rate down to 5.9 percent in September, just 0.4 percentage point above the top end of a range Fed officials consider full employment.

Such indicators of a strengthening economy outweighed policy makers' concerns about decelerating inflation. Oil prices are down about 17 percent this year, partly due to weaker global
growth prospects. Inflation expectations, measured by yield differences on U.S. Treasury notes and government inflation-linked bonds, signal inflation could remain below the Fed’s 2 percent target for several more years.

The personal consumption expenditures price index rose just 1.5 percent in August from a year earlier, the 28th month in a row it has been below 2 percent. Policy makers want to maintain a minimum level of inflation, because falling prices can encourage businesses and consumers to delay spending in the expectation of further price declines, reducing demand.

**Energy Prices**

“Although inflation in the near term will likely be held down by lower energy prices,” the FOMC said in its statement, policy makers determined that the risk of inflation remaining “persistently below 2 percent has diminished somewhat.”

Money-market investors in recent months had been giving more weight to the possibility that inflation won’t increase, forcing the Fed to raise interest-rates more slowly. That view may have changed after yesterday’s FOMC announcement.

Yields on two-year Treasury notes rose nine basis points to 0.483 percent yesterday. Fed funds rate futures show the probability of a rate increase by the September 2015 FOMC meeting is about 52 percent, up from a 42 percent chance yesterday.

“You can’t blame the markets for taking this as hawkish,” said Michael Pond, head of global inflation market strategy at Barclays Capital in New York.

If investors needed proof that the FOMC had shifted, it was in where the dissents came from, Pond said.

**Missing Target**

This time around the dissenter was Narayana Kocherlakota, president of the Minneapolis Fed, who has raised concerns about the Fed missing its inflation target for too long. Kocherlakota wanted the Fed to continue asset purchases and commit to holding the benchmark lending rate near zero until inflation expectations rose back toward 2 percent.

That contrasts with the September meeting when Fed presidents Richard Fisher of Dallas and Charles Plosser of Philadelphia dissented. Both pointed to strength in the economy that in their view didn’t square with the committee’s expectation to hold rates near zero for a “considerable time.”

U.S. central bankers forecast growth of 2.6 percent to 3 percent next year, fast enough to bring the unemployment rate down to 5.4 percent to 5.6 percent in the final quarter. That is about in line with private forecasters surveyed by Bloomberg News.
Rate Outlook

FOMC participants’ interest rate outlook for next year also fits with a scenario of a June rate increase that proceeds at quarter-point increases for the next several meetings. Their median forecast for the federal funds rate was 1.375 percent for the end of 2015.

The Fed’s statement in effect endorsed that forecast and brushed aside fears in the financial markets that such an outlook is at risk.

“It was obvious how much the Fed did not address the risks of external shocks, a stronger dollar, and fears of slowing growth and deflation abroad,” said Diane Swonk, chief economist at Mesirow Financial Holdings Inc. in Chicago. “It was a calculated move, a roll of the dice that they will have lots of time” to see how the U.S. and world economy develop over the next couple of months.

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