Commentary: Fed Chair notes labor market improvement, stresses flexibility in monetary normalization

- In testimony on the semiannual Monetary Policy Report to Congress today, Fed Chair Janet Yellen delivered few surprises. Testimony emphasized the extent of the improvement in the labor market and the importance of the outlook for inflation in guiding the path of interest rates. Specifically, the testimony noted, "it will be appropriate to raise the target range for the federal funds rate when, on the basis of incoming data, the Committee is reasonably confident that inflation will move back over the medium term toward our two percent objective."

- The testimony also noted that the Federal Open Market Committee (FOMC) is likely to alter its forward guidance in relatively short order, stating that, "if economic conditions continue to improve…the Committee will at some point begin considering an increase in the target range for the federal funds rate on a meeting-by-meeting basis. Before then, the Committee will change its forward guidance." Nonetheless, the Fed is looking to maintain flexibility, adding that "a modification of the forward guidance should not be read as indicating that the Committee will necessarily increase the target range in a couple of meetings."

- The other area of interest were comments on international developments. Yellen acknowledged the reality that external risks affect the US, but still views the balance of risks as "nearly balanced" and also expressed confidence in the strength of the domestic economy. It appears it would take a significant shock on the international front to alter FOMC policy at this point.

Key Implications:

- Given the sustained improvement in the labor market, inflation is now front and center for the FOMC. The Fed would like to see inflation hit a trough and turn higher before it raises rates. Given that we expect inflation to hit a trough sometime around May/June, the Fed will likely look to raise interest rates a short period afterwards. This is in line with our view that the Fed will hold off until September.

- The Fed will soon drop forward guidance, in order to give itself the flexibility to raise rates. This is sensible. Holding off on changing its forward guidance could lead markets into a false sense of complacency, leading to an abrupt change of sentiment when the Fed finally pulls the trigger.

- At the same time, the Fed does not want the removal of the "patient" language to lead to significant tightening in monetary conditions. It will remove the forward guidance in the literal sense, while maintaining it in the figurative sense over the next meeting or two.

- Absent a major shock to the outlook, a first rate hike from the Federal Reserve is in the cards for 2015. Nonetheless, while the Fed is intent on getting interest rates off the floor, they are likely to remain at relatively low levels for an extended period of time.

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