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TD Economics

Data Release: Yellen acknowledges downside risks to outlook, but indicates that Fed remains in wait and see mode

- Federal Reserve Chair Janet Yellen's semi-annual testimony to Congress noted the potential negative impact of the recent tightening in financial conditions and increasingly uncertain global backdrop, but also emphasized that at the moment these are still downside risks to the outlook. Only if tighter financial conditions prove persistent or worsen would they "weigh on the outlook for economic activity and the labor market."

- While noting the improvement in the labor market and that the unemployment rate is currently in line with FOMC member's projections for the longer-run normal level, the testimony acknowledged that more encompassing measures of slack (that include discouraged and part-time workers) remain elevated and that "while labor market conditions have improved substantially, there is still room for further sustainable improvement."

- Yellen stuck to the Fed's longstanding script in her description of low inflation, noting it is mainly due to transitory factors. As in the past, the testimony also noted downward lunge in inflation expectations, but attributed it to falling risk premiums rather than a truly worrisome sign. She also noted that while survey-based measures "are also at the low end of their recent ranges; overall…they have been reasonably stable."

- As she has in the past, Yellen acknowledged that "the federal funds rate is likely to remain, for some time, below the levels that are expected to prevail in the longer run." However, she also went further in explaining the Fed's thinking as to why, highlighting that it "may be…attributable to a range of persistent economic headwinds – such as limited access to credit for some borrowers, weak growth abroad, and a significant appreciation of the dollar – that have weighed on aggregate demand."

Key Implications

- Yellen's testimony did little to change the narrative of a data-dependent Fed waiting for evidence that the economy is still on track despite tighter financial conditions and increased global uncertainty.

- We detailed this view in a note yesterday. While the Fed is unlikely to get the confirmation they need before the March meeting, by June the persistence in domestic-led economic growth should be more apparent. Despite the move in market expectations to price out rate hikes completely in 2016, we still view two rate hikes this year as a material probability.

- The Fed is not taking a strict interpretation of the unemployment rate and will allow it to drift further below its long-run target before seeing it as a constraint. Nonetheless, several other labor market metrics have continued to show improvement, including the job openings, hiring and quit rate, which all moved higher in the most recent data for December.

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