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Slow Normalization or No Normalization?

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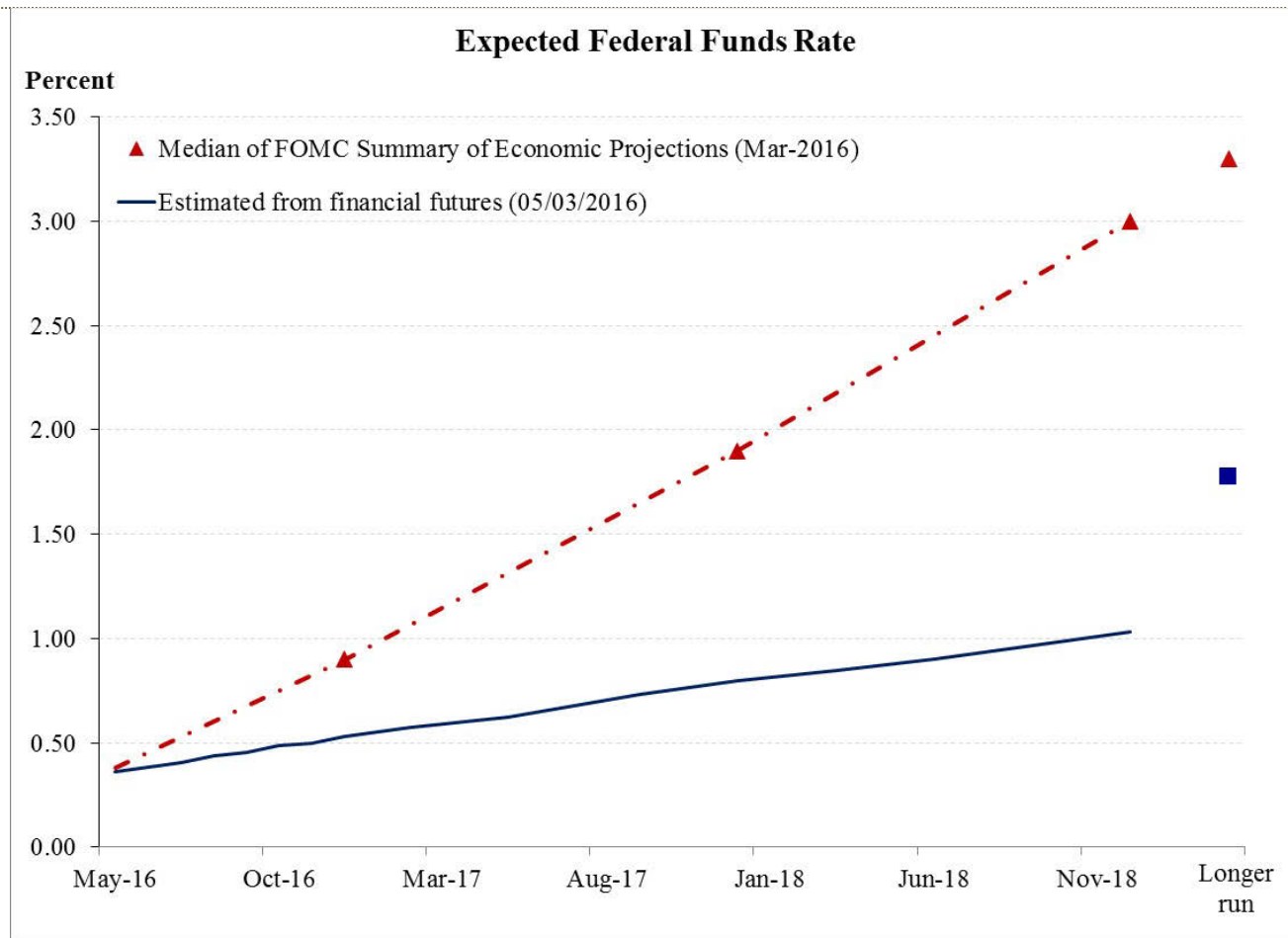
Santa Barbara, Calif.

Introduction

Slow normalization or no normalization?

- Recent U.S. monetary policy discussions have been dominated by issues surrounding the possible pace of increase in the FOMC's policy rate.
- The FOMC has laid out, via the Summary of Economic Projections, a data-dependent “slow normalization,” whereby the nominal policy rate would gradually rise over the next several years provided the economy evolves as expected.
- Market-based forecasts of FOMC policy, in contrast, envision “almost no normalization,” whereby the policy rate would be changed only a few times in the next several years.
- Which of these two views is more nearly correct?

Expected federal funds rate path



These remarks

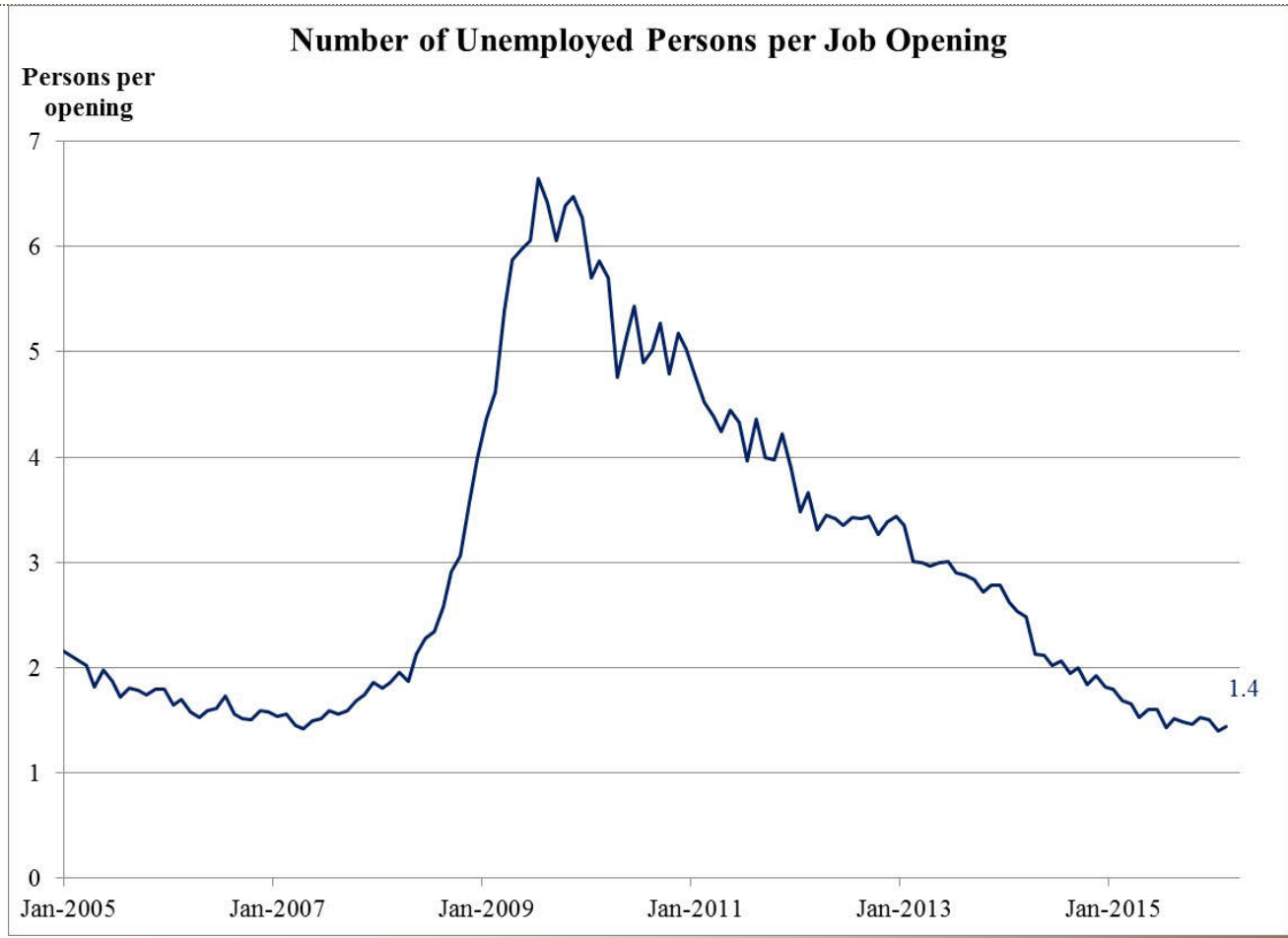
- In these remarks I will briefly compare and contrast these two views.
- In favor of the FOMC scenario:
 - Relatively strong U.S. labor markets.
 - U.S. inflation measurements that are closer to 2 percent.
 - Waning international headwinds.
- In favor of the market-based scenario:
 - Slow U.S. real GDP growth.
 - Low U.S. inflation expectations.

Strong U.S. Labor Markets

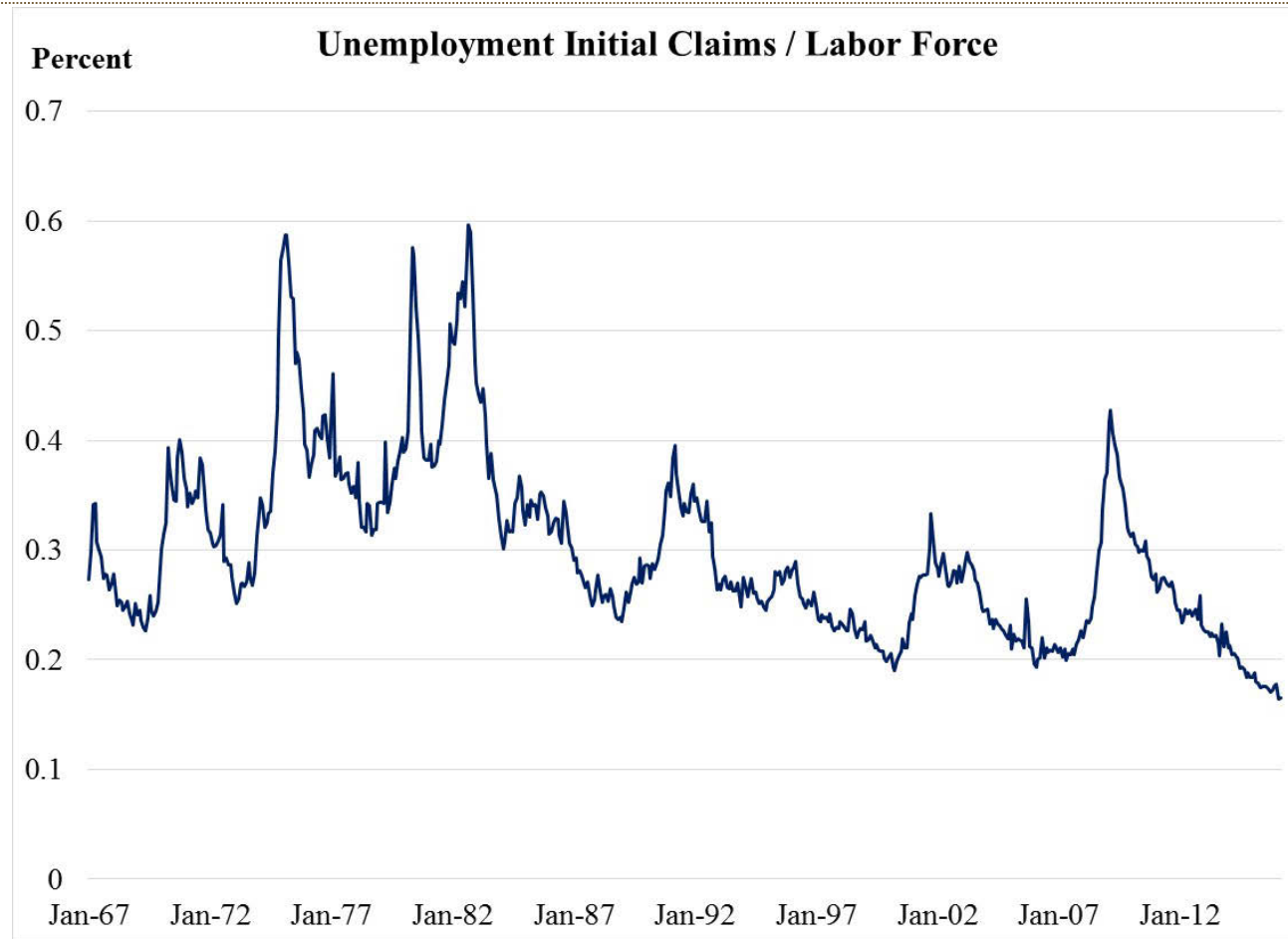
Relatively strong U.S. labor markets

- U.S. labor markets are at or possibly well beyond reasonable conceptions of full employment.
- Job openings per available worker are at a cyclical low.
- Unemployment insurance claims relative to the size of the labor force are at a multi-decade low.
- Nonfarm payroll employment growth has been impressive.
- The level of a labor market conditions index, which aggregates many measures of labor market performance into a single index, is well above historical averages.*
- In short, labor markets are relatively tight.

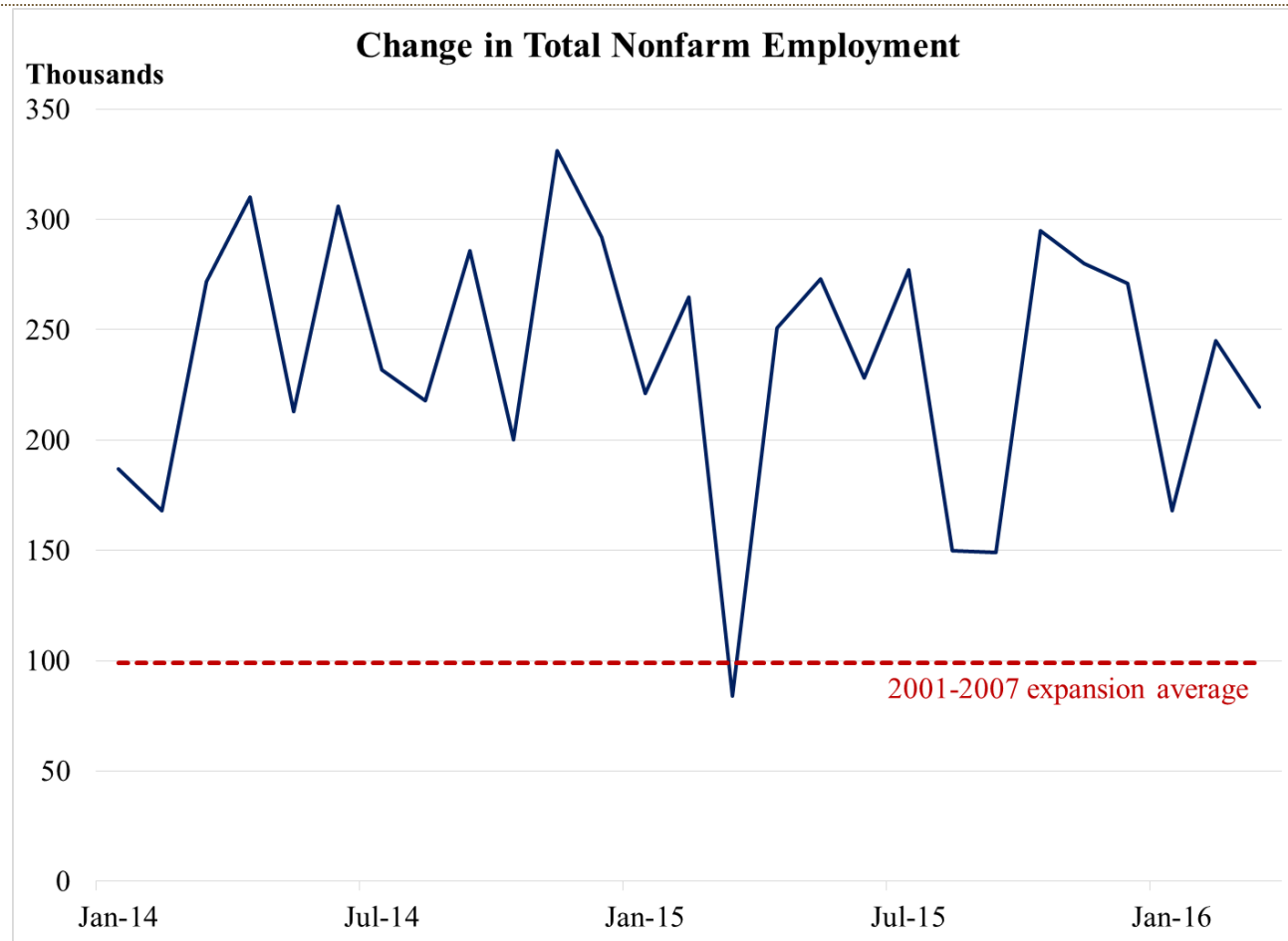
Labor market tightness at a cyclical high



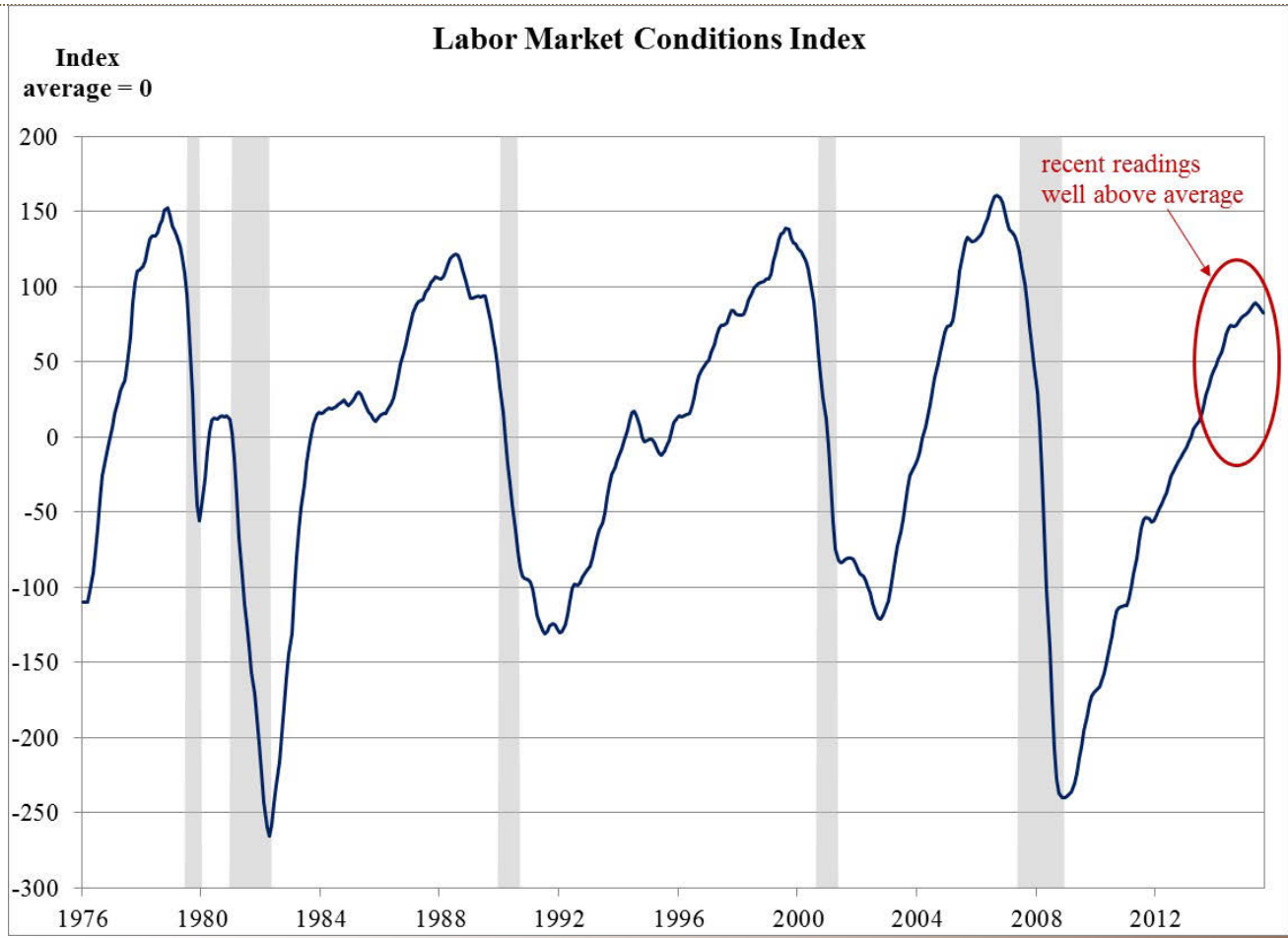
Unemployment insurance claims at a historical low



Strong employment growth



Labor market conditions well above average

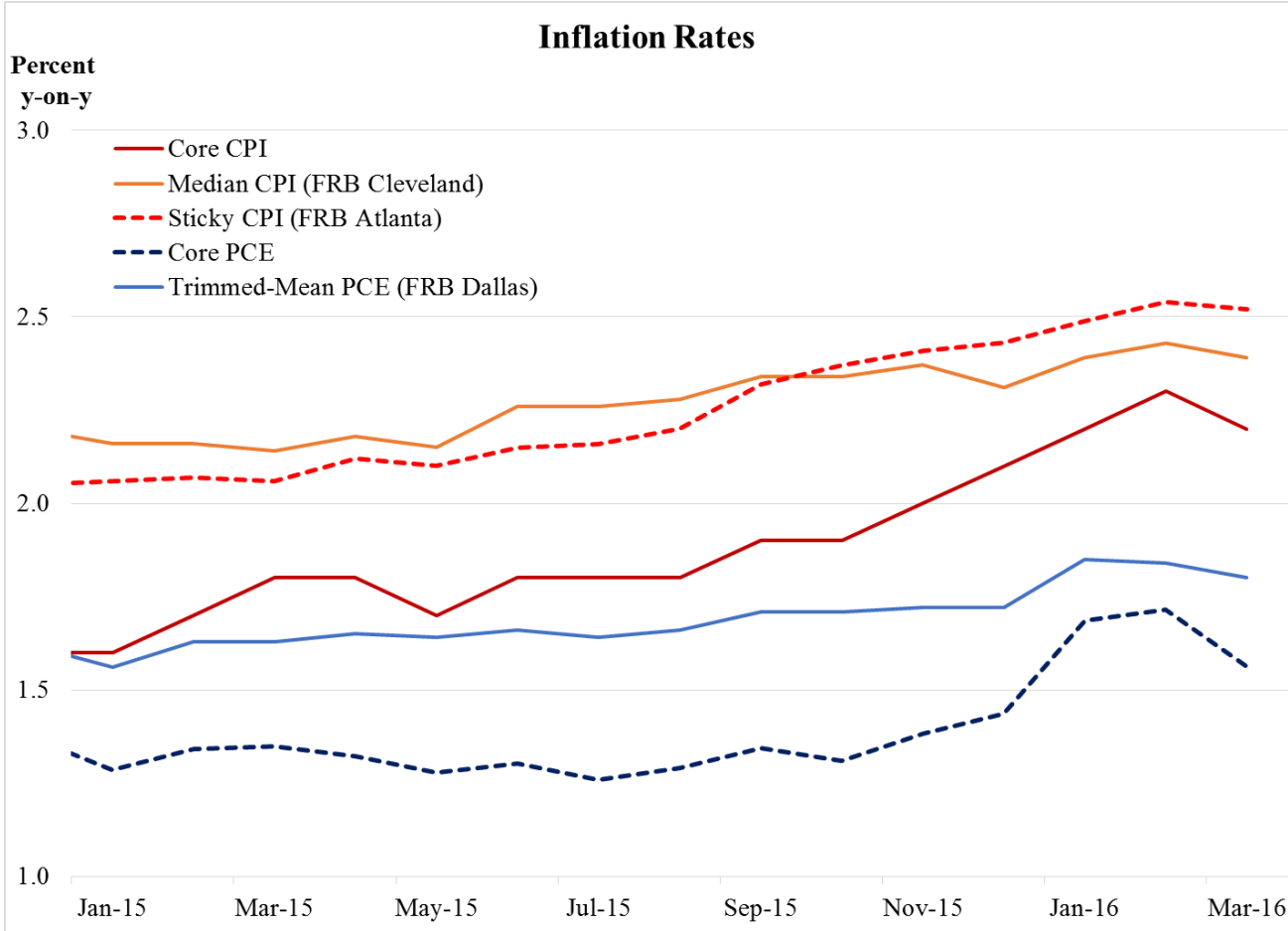


U.S. Inflation Closer to 2 Percent

U.S. inflation closer to 2 percent

- Inflation has been relatively low in the U.S. during the last several years.
- Large movements in oil prices have had a major impact on headline inflation.
- Measures intended to give an indication of inflation movements net of oil price effects have been trending somewhat higher.

U.S. inflation closer to 2 percent



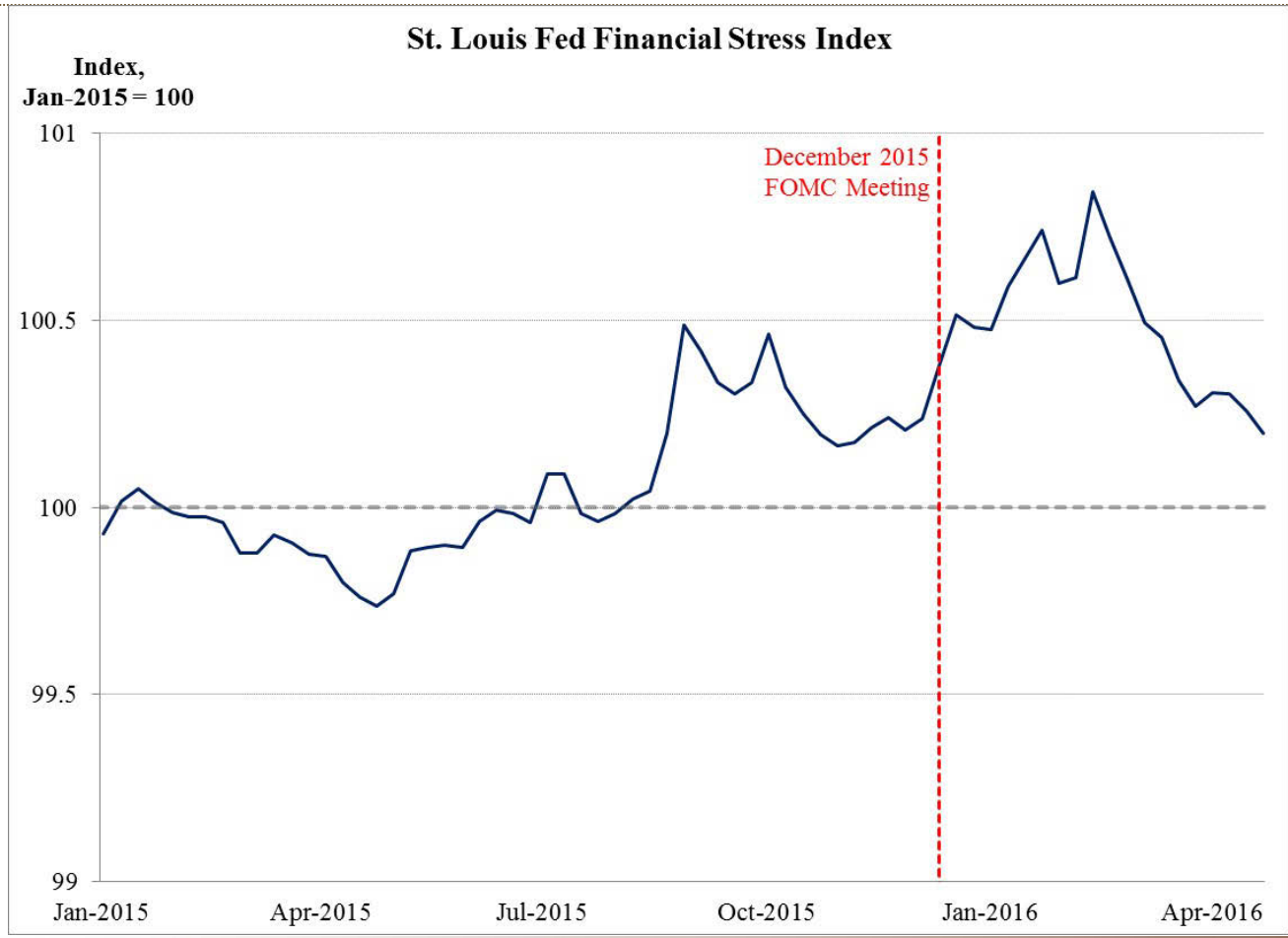
Source: Bureau of Labor Statistics, FRB Cleveland, FRB Atlanta, Bureau of Economic Analysis, FRB Dallas.
Last observations: March 2016.

International Factors Waning

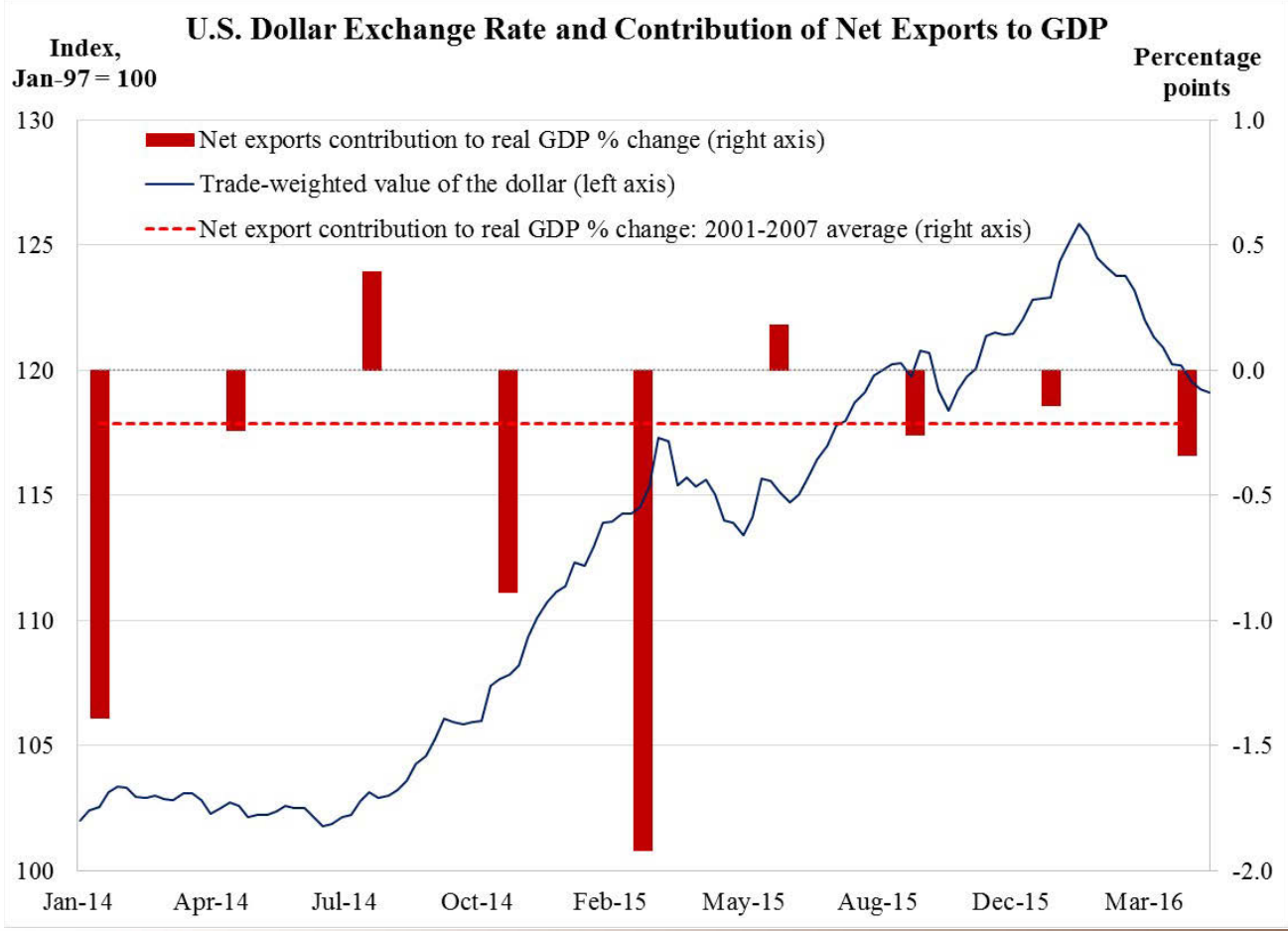
International factors waning

- International influences on the U.S. economy have been widely discussed in global financial markets during the last several years.
- Those factors appear to be waning during the first half of 2016.
- Financial stress has fallen according to recent readings.
- The effects of a stronger dollar appear to be waning.

Financial stress has subsided



Waning effects of a stronger dollar

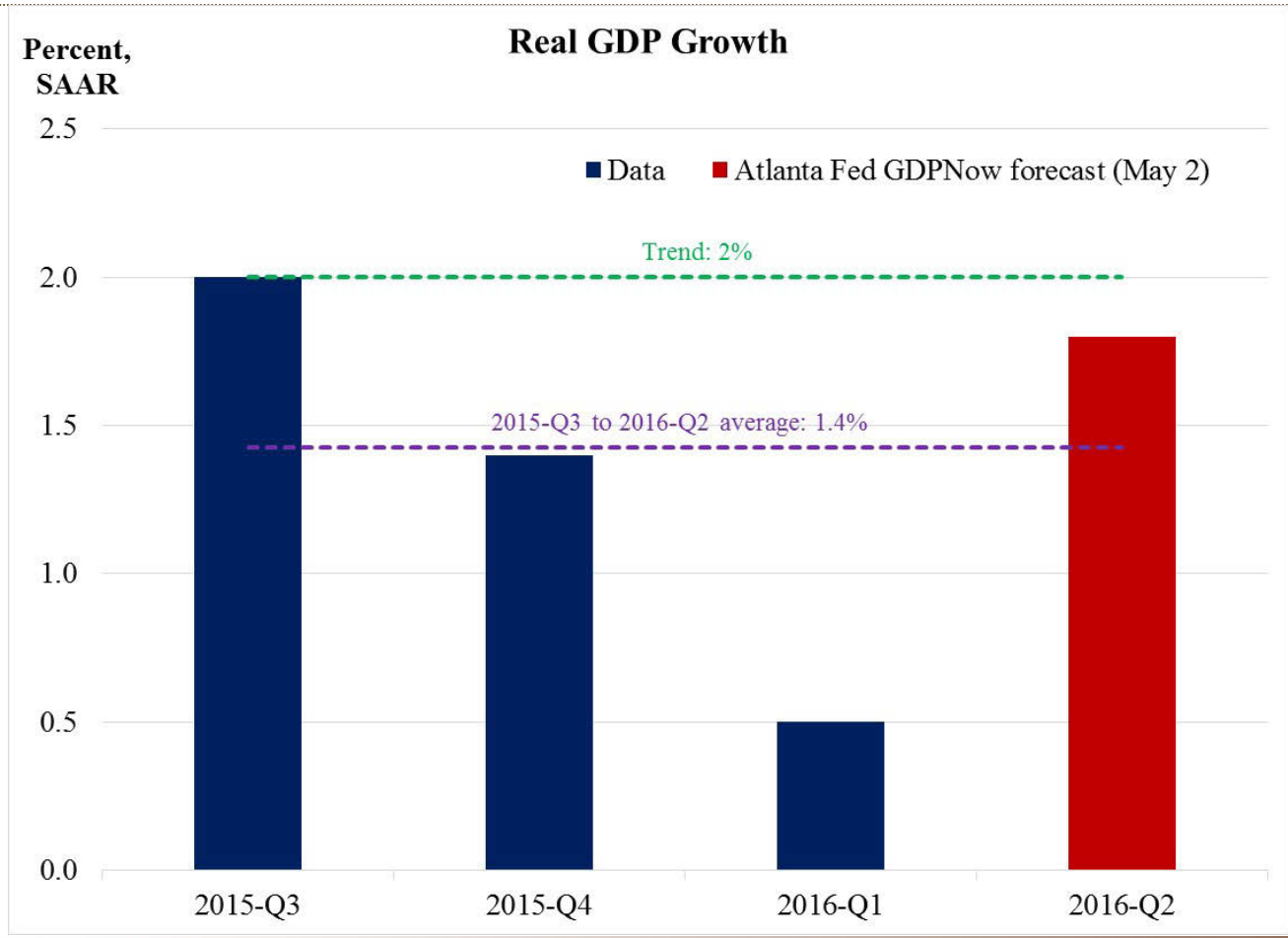


Real GDP Growth Below Trend

Real GDP growing at a below-trend pace

- U.S. real GDP growth has been slower than trend in recent quarters.
- First-quarter 2016 real GDP growth was just 0.5 percent at an annual rate according to the most recent estimate.
- This estimate may be influenced by the “residual seasonality” issue: First-quarter real GDP has been low since 2009.
- Still, combining actual data from the second half of 2015, the first quarter of 2016, and tracking estimates for the current quarter, the suggestion is that the U.S. is growing below a trend pace of 2 percent.

Below-trend real GDP growth

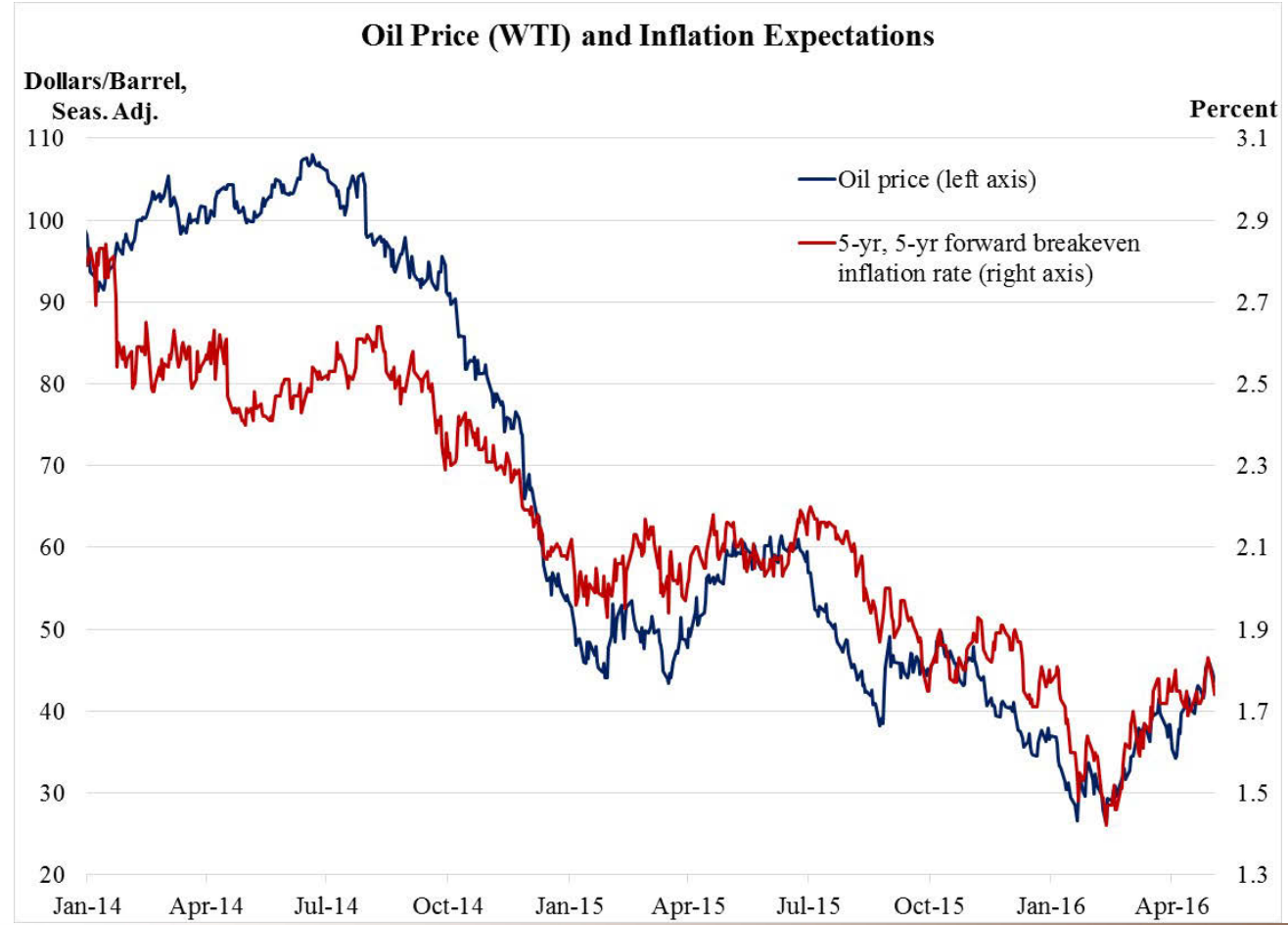


Inflation Expectations Still Too Low

Inflation expectations

- Market-based measures of inflation expectations were relatively satisfactory during the summer of 2014.
- They fell with oil prices and renewed a downward trend beginning in late 2015.
- Recently, market-based inflation expectations have recovered somewhat.
- However, they remain low compared with the levels observed in the summer of 2014.

Inflation expectations recovered with oil prices ...



... but remain uncomfortably low

	07/01/2014	12/15/2015	02/11/2016	04/29/2016
2-year *	188	94	95	171
5-year **	200	122	94	160
10-year **	226	148	118	171
5-year forward **	252	174	142	182

* Inflation compensation: continuously compounded zero-coupon yields (basis points).

** Breakeven inflation rates (basis points).

Market-based inflation expectations

- Market-based measures of inflation expectations are based on CPI inflation.
- The FOMC's preferred inflation measure is based on PCE inflation.
- A rule of thumb for translating between the two indexes is to subtract 30 basis points from CPI inflation to get to PCE inflation.
- Using this rule of thumb and the data in the previous table—and not making any further adjustment for liquidity or risk premia—markets can be interpreted as expecting just 1.41 percent PCE inflation over the next 10 years.

Conclusions

Conclusions

- The FOMC median projection for the policy rate suggests a gradual pace of rate increases over the next several years.
- The market-based expectation for the FOMC policy rate is much shallower, implying only a few increases over the forecast horizon.
- Evidence from labor markets, inflation readings and global influences suggests the FOMC median projection may be more nearly correct.
- Evidence from readings on GDP growth and market-based inflation expectations suggests the market view of the path of the policy rate may be more nearly correct.



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