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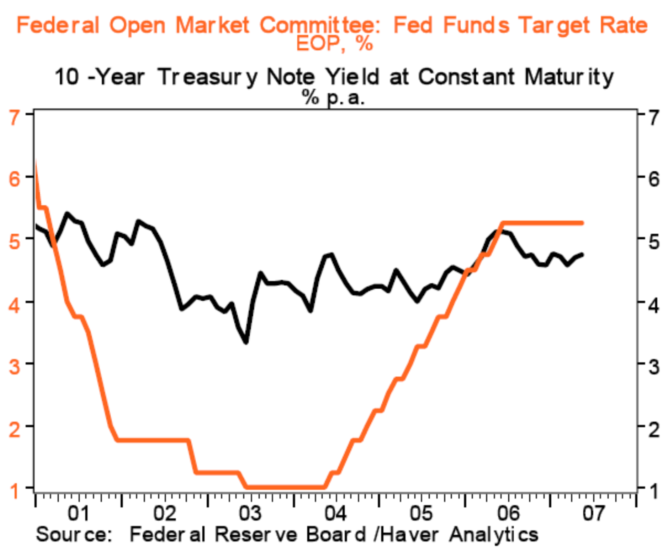
Economic Commentary

The Fed Gets Bullish

Although the Federal Reserve left the target federal funds rate unchanged at 5.25% today, it made some important adjustments to the wording of its statement on the stance of monetary policy. The changes in language suggest an improved forecast for real GDP growth and a tougher standard for assessing inflation risk.

First, instead of dwelling on the fact that real GDP growth slowed in the first quarter, The Fed said growth "appears to have been moderate during the first half" of 2007. Given that the Fed, like everyone else, knew real GDP growth was 0.7% in the first quarter, calling growth in the first half "moderate" implies the Fed is forecasting strong growth in the second quarter. Otherwise, growth would not be "moderate" in the first half, but rather "slower than trend."



Second, the Fed noted that readings on "core" inflation (which excludes food and energy) have improved, deleting the word "elevated" from its description of that measure of price changes.

But, more importantly, immediately after noting the change in core inflation, the Fed added the following new sentence to the statement. "However, a sustained moderation in inflation pressures has yet to be convincingly demonstrated."

We interpret this new sentence in a couple of ways. First, the Fed is raising the bar on rate cuts. It is not enough for core inflation to come down to the very top of the "comfort zone" of 1% to 2%. A necessary (although probably not sufficient) prerequisite for the Fed to cut rates would be for the Fed (and perhaps consumers and investors as well) to become convinced that core inflation will remain in the comfort zone for a prolonged period of time.

Second, unless core inflation gets back down into their comfort zone and appears likely to remain there for a prolonged period, the Fed is likely to raise rates again.

Given our view that real GDP will be strong from the second quarter forward and that inflation is likely to rise, not fall, we believe the latter interpretation - that rate hikes are more likely - contains more market significance.

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