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US: The Fed Buys Time as the Outlook Evolves

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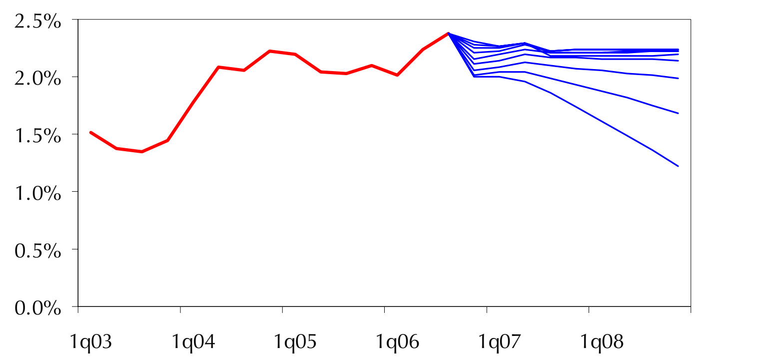
- The Vice-Chairman of the Fed, Kohn, delivered his first speech on the economic outlook yesterday. In light of his clout within the Fed and proximity to the Chairman, the tone of Kohn's speech should provide a preliminary sense of the mainstream thinking (in particular among the Governors) within the Federal Open Market Committee.

- The gist of the speech, however, is largely similar to the general nuance of the December minutes and the post-meeting statement. Namely, moderate economic growth against the backdrop of a gradual decline in core inflation. Nonetheless, since the prospect of lower core inflation in 2007--specifically with respect to its pace and magnitude--is still subject to some degree of uncertainties, the policy bias is still more inflation-sensitive than growth-sensitive. But Vice-Chairman Kohn also recognizes that the "range of uncertainty around any forecast (on growth and inflation) is considerable" (parenthesis added). This suggests that the general consensus on monetary policy appears to be for a steady target fed funds rate, at least until there is a clearer sense on which direction the majority of the incoming indicators lean. Hence, our forecast for a steady target fed funds rate at 5.25% through spring appears to be consistent with the foregoing assumptions.

- The main determinant factor in the policy forecast at this juncture appears to be focused mainly, if not entirely, on the medium-term projections for inflation. Indeed, if inflation pressures broaden unexpectedly, longer-term inflation expectations shift out of the range of fluctuation in recent periods and the elevated readings on core inflation remain persistently higher than anticipated, then the Fed would most likely firm policy, at least another time, for insurance purposes. Hence, a reasonable forecast range for core inflation, which utilizes a formal model, might be one way to determine the likelihood of another rate increase in the near-term.

- There are a variety of approaches that economists and policymakers can employ to gauge a possible range for inflation in the short- to medium-term. Notably, the most common is the Phillips curve, which is dependent on some measure of economic slack. Or similarly, some variant of the Phillips curve that includes additional factors such as inflation expectations, supply shocks and inflation persistence. Recent empirical research, however, shows that a simple random walk model (that uses only previous period inflation as an input) or a "consistent expectations" model (that uses a weighted average of past inflation rates based on a "signal-to-noise ratio")

Core PCE Price Index (% Chg. over-a-year-ago)



Source: BEA, Proprietary Data

could outperform the standard Phillips curve model for inflation. (A recent paper by Kevin Lansing of FRB of San Francisco entitled, “Time-Varying U.S. Inflation Dynamics and the New Keynesian Phillips Curve”, discusses the methodology of the latter model.) In a simple exercise, the forecast range for core inflation through 2008--using a similar approach to the “consistent expectations” methodology--is estimated to either remain somewhat steady or recede eventually to more comfortable levels. As a result, the risk of another rate hike at this juncture appears to be reasonably low.

- Finally, the general rhetoric from policymakers implies a sub-trend growth forecast in the first-half of 2007, and possibly the economy could pick-up to “…something in the neighborhood of the growth rate of …potential” by the second-half of 2007. However, if economic growth remains around the 2.0% to 2.5% range in the first-half of 2007, and subsequently downshift to below 2% on average, then policymakers would likely respond appropriately with more accommodative policy. Therefore, our growth projections of sub-2% in the second-half of 2007 is consistent with our rate reduction forecast at each meeting (from June through December 2007), which would lower the target fed funds rate to 4.0% by the end of this year. While our Fed policy forecast is contingent on our sub-2% growth projection and a gradual improvement in core inflation in the second-half of 2007, we have to acknowledge that the risks to the outlook continue to evolve unevenly, and that it is necessary to monitor the on-going developments on the economy continuously to refine our forecast, if necessary.

Updated Projection

(%)	3q06	4q06E	1q07E	2q07E	3q07E	4q07E	2006E	2007E
Real GDP (saar)	2.0	2.5	2.5	2.0	1.8	1.4	3.3	2.2
Real PCE (saar)	2.8	4.0	2.4	1.6	1.6	1.2	3.2	2.4
Unemployment Rate (avg)	4.7	4.5	4.6	4.7	4.8	5.0	4.6	4.9
Core PCE Price Index (oya)	2.4	2.3	2.2	2.0	1.9	1.9	2.2	2.0

Source: UOB forecast and actual data from respective sources