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Economic Commentary

Fed May Pause "At Some Point" – But Uncertainty Reigns

Federal Reserve Chairman Ben Bernanke testified before the Joint Economic Committee today on his outlook for the U.S. economy and monetary policy. On the economy, Chairman Bernanke was fairly upbeat, saying that "the prospects for maintaining economic growth at a solid pace in the period ahead appear good." However, Mr. Bernanke warned that the housing market was showing signs of "softening" and could be a drag over the next two years.

His outlook for inflation was favorable, but he was concerned that higher commodity prices – especially energy – could pass through to core inflation.

This diagnosis of the economy has put Chairman Bernanke and the Fed in a difficult position. After 15 straight rate hikes the Fed is being extremely cautious about going too far. The lag between Fed action and economic reaction makes this challenge even more difficult. As a result, the Fed is increasingly data dependent.

In an important passage from Chairman Bernanke's testimony, he said that even "if in the Committee's judgment the risks to its objectives are not entirely balanced, ***at some point*** in the future the Committee may decide to take no action at one or more meetings in the interest of allowing more time to receive information relevant to the outlook."

While some in the market judged this to mean that the Fed was finished, we view it as a sign of flexibility and uncertainty. If the economy slows and inflationary pressures moderate, it is entirely possible that the Fed will stop at 5% after their meeting in May.

However, we continue to believe that the neutral Fed funds rate sits between 5.5-6%. As a result, with the Fed still below neutral, economic growth will remain strong, while commodity prices and inflation will continue to rise. Although the Fed may put rate hikes on hold at some point, underlying trends suggest that a pause short of neutral will be temporary.

Increased transparency does not always mean more certainty. The Fed is data dependent, which means the market will be too. But investors who watch commodity prices, especially gold, will gain the most insight. The Fed will not be done tightening until commodity prices peak and pull-back to substantially lower levels.

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