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Economics Group

WELLS FARGO SECURITIES

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Monetary Policy and the Economy: A Balancing Act

Our outlook for monetary policy is rooted in our economic forecast. That said, we also take into account risks to the outlook and expectations for how the Federal Open Market Committee (FOMC) will weigh these risks.

Divergence Between FOMC and Markets

In the dot plot published following the December FOMC meeting, the median participant indicated four fed funds rate hikes during 2016 followed by another four hikes during 2017. Given recent financial market developments, futures are currently pricing in only one rate hike for 2016. We will not receive updated FOMC projections until the March meeting, but we believe that their latest projections are too aggressive.

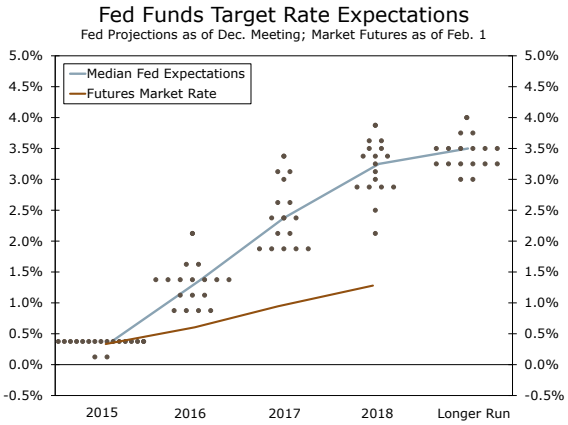
In a recent report, we noted that various monetary policy rules yielded a wide range for the "appropriate" fed funds rate. Given the sensitivity of the rules to the underlying assumptions, we are hesitant to put too much weight into any one specification. That said, we plot two of the more plausible rules, which suggest that the fed funds rate should be set as the equilibrium nominal fed funds rate (funds rate consistent with an economy operating at potential and stable inflation) plus the inflation gap and less the output gap. Using both the headline unemployment rate and the U-6 underemployment rate, we can see that the pace of policy tightening should proceed slowly. Our forecast runs in the middle of both policy rules.

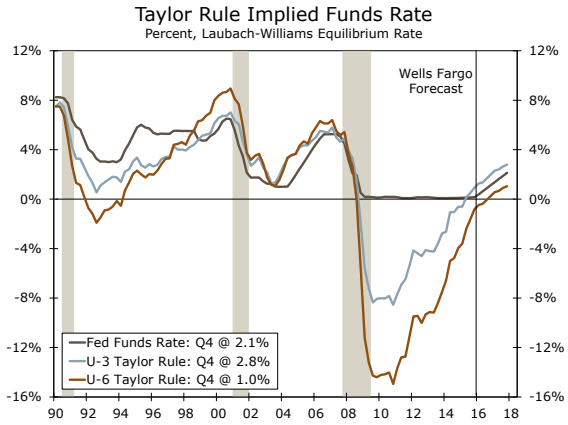
Risks to Outlook for Fed Tightening

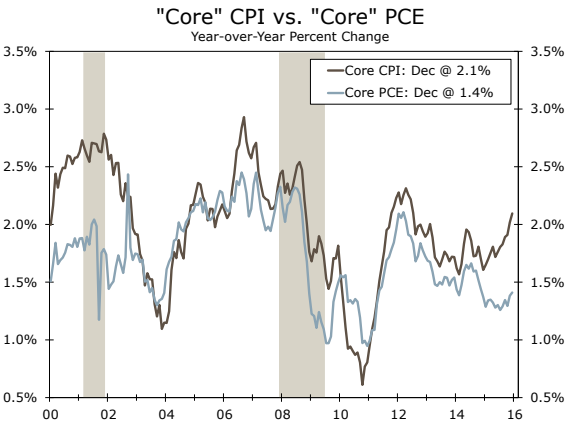
Yet, there remain substantial risks to the outlook, both to the upside and the downside. That said, we believe our forecast for the funds rate will roughly balance the risks in the eyes of the FOMC. To the downside, which is what financial markets seem to be weighing more heavily than the FOMC and our own forecasts, there are the risks that lower commodities prices, financial market volatility and/or a slowdown in global growth destabilize the U.S. economy and force the Fed to backpedal. In addition, the Fed's concern with credibility could slow its tightening further if longer-term inflation expectations remain depressed.

On the flip side, there is the risk that inflation will outpace what many expect, leading the Fed to tighten faster than our forecast. Any stabilization in energy prices, let alone a rebound, would support the headline figures. Core inflation should also continue to firm. Tightening in the labor market is already supporting wages and the disinflationary effects from healthcare on the core PCE should lessen. In addition, looking at other measures of core inflation, such as the core CPI, we see that the underlying inflation trend is likely stronger than the PCE numbers indicate (bottom chart).

The Fed has also acknowledged the lags and imprecision of monetary policy. That is, trying to "fine-tune" the unemployment rate toward full employment once it has fallen below full employment is a risky proposition. By tightening sooner, the Fed hopes to avoid overheating the labor market to prevent a significant overshoot of inflation. We believe the Fed will view these risks as largely offsetting with the path of tightening that we forecast.







Source: Federal Reserve Board, Bloomberg LP, U.S. Depts. of Labor & Commerce and Wells Fargo Securities, LLC

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