Chart of the Week:
Yellen's Sleight of Hand

March 2015

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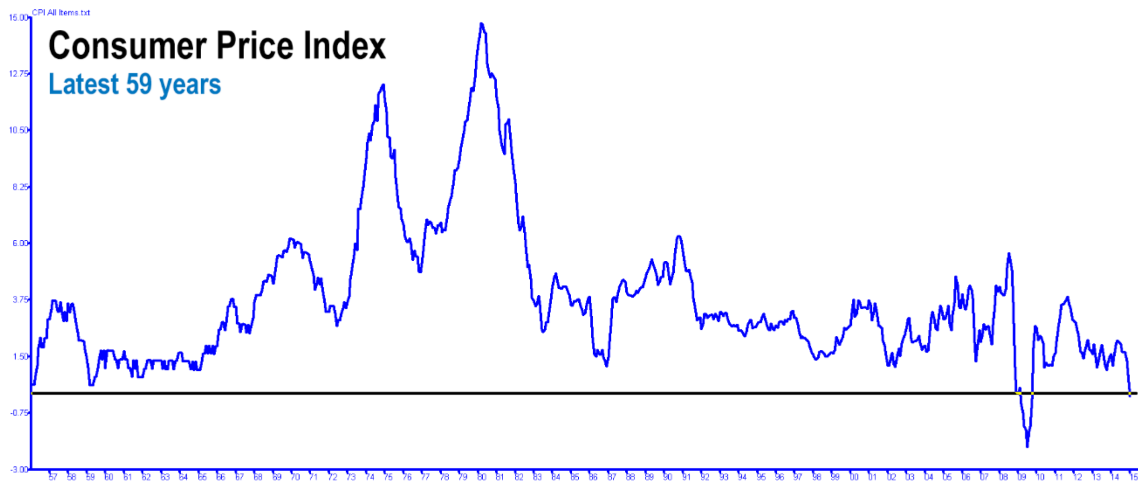
YELLEN'S SLEIGHT OF HAND

Following Janet Yellen's semi-annual report to Congress, the so-called Humphrey-Hawkins testimony, these headlines streamed across the Reuters newswire indicating the latest train of thought from the Yellen Fed.

> **YELLEN: `PATIENT' MEANS LIFTOFF UNLIKELY FOR COUPLE OF MEETINGS**
> **YELLEN: GUIDANCE CHANGE TO MEAN LIFTOFF POSSIBLE AT ANY MEETING**
> **YELLEN: FED WILL RAISE WHEN `REASONABLY CONFIDENT' ON INFLATION**
> **YELLEN: FED WILL CHANGE FORWARD GUIDANCE BEFORE RAISING RATES**

Over the last two months, the focus for most Fed watching conversation has been the removal of the long-held phrase "for an extended period of time", which was loosely used to describe the Fed's stance on interest rates. Roughly translated, interest rates would remain lower for longer and would stay low for "an extended period of time." For stock markets that are generally averse to interest rate hiking cycles and monetary tightening, the notion was to handicap proximity to the next rising rate cycle, with the markets assuming that "extended" always meant several months.



Source: BLS. U.S. Consumer Price Inflation 1956 through 2015

In the last few weeks, the Fed has deftly removed the word "extended" and has since replaced it with the thought of remaining "patient." At the recent report, Mrs. Yellen clarified that "patient" refers to a time period encompassing "at least the next couple of meetings."

While the majority of this week's conversation surrounding monetary policy was about the word "patient", Fed watchers may have missed an even more important, yet subtle alteration. Specifically, a Fed that appears to be quietly reengineering its monetary trigger away from the unemployment rate and toward the direction of inflation.

In her testimony, Mrs. Yellen said, "The Committee expects inflation to decline further in the near term before rising gradually toward 2 percent over the medium term." She went on to imply that the Fed may not actually begin raising interest rates until inflation is trending upward and a 2% target materializes in

“the medium term view.” She stated, “Right now, I don’t see any evidence of inflation heading above 2%, but we need to be forward looking."

This is potentially positive news for the capital markets because, the very next day, it was announced that the annualized rate of Consumer Price Inflation (CPI) fell to a negative reading of -0.1% year-over-year, which dropped this gauge back into negative territory for the first time since October 2009. Prior to that, we had not seen a negative annualized CPI reading since 1955.

This signifies that, theoretically, the U.S. is joining a large portion of the world’s economy that has already been in deflation. Further, with energy and other commodity prices still trending downward, the U.S. will likely see a number of negative headline CPI readings in the months ahead. For the Fed, this surely indicates that 2015 may not see an interest rate hike at all, and that if the new benchmark over time becomes the inflation rate, rather than the unemployment rate, the Fed may not be hiking rates for quite some time.

At Sierra, we view this development as a positive signal for the Treasury, high grade corporate and municipal bond markets, which may not have to cope with a Fed tightening cycle for a very long period of time. For equity markets, the initial reaction could also be positive, but may be tempered in the months ahead if we begin to see evidence that falling prices are starting to have a negative impact on profit margins and the overall earnings outlook. In that event, falling inflation will be an even greater boost for fixed income investors.

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