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Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

JUNE 26, 2011

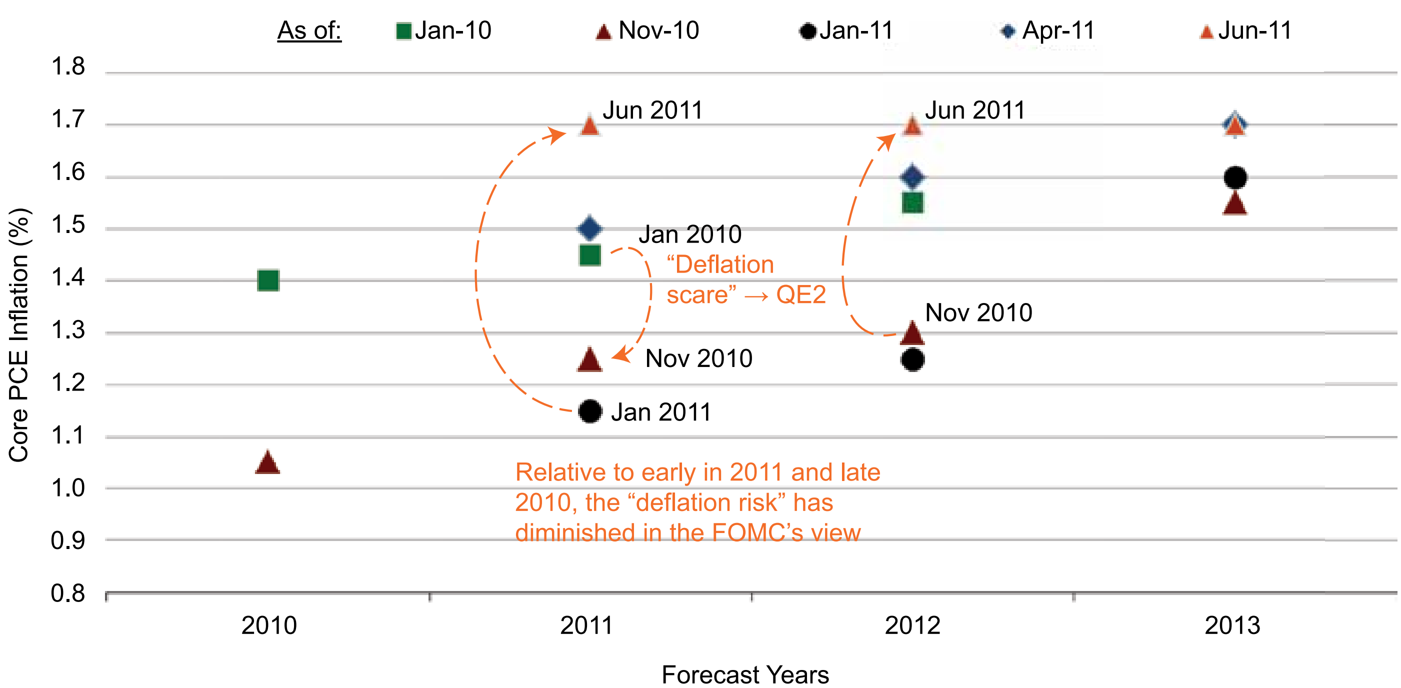
Mr. Bernanke and His Critics, Revisited ("Too Much" versus "Too Little")

A few weeks ago we noted that Federal Reserve Chairman Ben Bernanke has two main sets of critics: those who assert the Fed has done too much and those who claim the central bank has done too little. The "too much" camp points to rising inflation, commodity prices and the Fed's bloated balance sheet as evidence of too much easy money sloshing around the system. The "too little" camp points to high unemployment as evidence that the Fed is falling short of its legislated mandate to steer the economy to price stability and full employment. We think both groups ascribe too much power to monetary policy.

This week, both groups of critics were disappointed by the Bernanke press conference. Why? Because while Bernanke did not promise to take away the proverbial punch bowl today, he isn't mixing up another batch of the monetary elixir just yet either. At the press conference Bernanke framed the FOMC's view: policymakers see the first-half GDP slowdown as "temporary". As auto production rebounds and lower energy prices ease the consumer's pain, economic growth in the second half of 2011 should improve and accelerate in 2012 (though Bernanke might actually be slightly more bearish than the FOMC consensus on the growth outlook).

This growth optimism by no means implies the Fed will begin hiking soon, but policymakers feel they have done enough for now. On this point, Bernanke was clear: QE3 is not imminent. Bernanke pointed out that a year ago "inflation was very low and falling" and that QE2 has "been very successful in eliminating deflation risk." Today, core measures of inflation are rising at 1-1.5% compared to a year ago and appear to be trending higher toward the Fed's target. **This is the critical difference between today and a year ago: deflation concerns have diminished.** A more significant deterioration in the economic

FOMC's CORE PCE INFLATION FORECAST SHOWS 'DEFLATION FEARS" HAVE DIMINISHED



data and a turnaround in recent inflation trends would be required to tilt to scales back the other way and re-ignite the debate about QE3.

Perhaps the best visualization of this concept is in the FOMC's own economic forecasts, which are released quarterly. To summarize:

Economic Growth Will Be Slower: The FOMC has marked down its 2011 real GDP forecast significantly since the start of the year (now below 3%). In addition, the FOMC lowered its 2012 forecast as well. Downgrades to 2012 are important to watch as it signals a broader acceptance among members of the Committee about a slower pace of growth.

The Unemployment Rate Will Be Higher: The FOMC sees the unemployment rate falling to between 8.5% and 9% in 2011 and around 8% in 2012. This is dramatic when compared to the Committee's January 2011 forecasts, which pegged the 2012 unemployment rate at 7%.

Inflation (Headline and Core PCE) Will Be Near Target: This is probably the best one-page summary of the last 2 years of monetary policy decision-making **(see chart above)**, showing the evolution of the FOMC's forecast for core PCE dropping from January 2010 to November 2010 as the "deflation scare" prompted QE2 then reversing course entirely over the first half of 2011 as deflation worries subsided.

For now, the FOMC appears to think current monetary policy settings (Federal funds rate and size of the Fed's balance sheet) are appropriate -- or at least until the FOMC meets again in early August – much to the chagrin of the critics.

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333 South Grand Avenue, Los Angeles, CA 90071 | payden.com