What Are The FOMC Minutes Telling Us?

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The release of the minutes of the January Federal Open Market Committee (FOMC) of the Federal Reserve (Fed) caused a tremor in the bedrock of investor euphoria last week. The minutes confirmed that the cost/benefit analysis of quantitative easing (QE) is at center of policy debate right now. However, the minutes did not provide a definitive signal that the program may be cut short. In particular, it is not clear where Chairman Bernanke and Vice Chair Yellen stand. I believe the level of debate slightly raises the odds that QE will end this year.

The Fed staff revised up their economic forecast. Fed officials' own views also look to have brightened slightly. They referred to an economy on a "moderate growth path" with reduction in downside risks. Better business conditions were noted across the Fed regions, but they also noted downside risks due to the sequester and the impact of the tax hike on consumers. There was also some debate about potential economic growth in the U.S. having fallen. This is a topic of significant debate within Columbia Management and is at the heart of our market valuation analysis.

Perhaps the most significant feature of the minutes was the debate about QE's costs and risks. This had been suggested by public comments from Fed officials before meeting. The FOMC asked staff to do more work on the costs/risks question and to report back at a later meeting. There does not appear to have been significant discussion of the recently introduced unemployment and inflation thresholds for QE. The point about the 6.5% unemployment threshold for changes in the federal funds rate not being a hard trigger for rate hikes was mentioned again. I expect to hear more on this at Chairman Bernanke's Humphrey-Hawkins testimony this week.

The discussion about the costs and risks of QE was balanced by concerns about withdrawing policy support too early. I would not be surprised if Yellen expressed that view at the meeting. The committee consensus on QE seems to be turning, but they are not about to stop the program suddenly. The minutes hinted that a potential compromise would be to buy fewer assets, but hold them longer. In the way the Fed thinks about QE's impact, this could be designed as equivalent policy. However, it is unclear how markets would react. Exactly what markets are discounting by way of the magnitude and frequency of asset purchases and sales is uncertain.

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