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FED CHAIR YELLEN'S SEMIANNUAL TESTIMONY TO CONGRESS

Testimony

Federal Reserve Chair Yellen delivered the Fed's semiannual monetary policy testimony to Congress today before the Senate Committee on Banking. She will deliver the same testimony before the House Financial Services Committee tomorrow. The testimony reflected a more hawkish tilt from the Fed relative to expectations, as it placed a March rate hike on the table. This testimony follows more hawkish comments from other Fed presidents recently (Williams and Harker) that a March rate hike should be considered.

Yellen emphasized that further progress in labor markets and inflation should lead to further near-term increases:

> "Incoming data suggest that labor market conditions continue to strengthen and inflation is moving up to 2 percent, consistent with the Committee's expectations. At our upcoming meetings, the Committee will evaluate whether employment and inflation are continuing to evolve in line with these expectations, in which case a further adjustment of the federal funds rate would likely be appropriate."

Yellen also emphasized that waiting too long to normalize policy would be unwise and risk placing the economy into recession. This could eventually apply steeper rate normalization to a higher terminal rate.

Yellen also noted that the FOMC expects that the neutral federal funds rate will raise over time. This is consistent with the Committee's view of improving economic performance.

We have maintained that improving economic data, the pickup in inflation and continued strong job growth should enable the Fed to move in March (see "US: Strong January Job Growth and Better Economic Data Should Encourage Fed to Consider March Hike", February 3, 2017). If the February Employment Report shows solid job gains and a rise in wages and if headline PCE inflation continues to increase (PCE inflation rose 1.6% yr/yr in December 2016, a full percentage point higher than its 0.6% yr/yr rise in December 2015)– it will be difficult for the Fed to find reasons to not increase rates. Failing to do so runs the risk of harming its credibility. Moreover, the US dollar, an ongoing concern of the Fed, has receded in recent weeks. A rate hike in March would give the Committee a better chance to achieve its forecasts for three rate increases this year and lessen the risk of falling behind the curve.

However, in recent years, as the economy has improved and the Fed has moved closer and closer to its dual mandate, the Fed has used a variety of ever-changing explanations not to raise rates. So while all of the factors are in place for a March hike, the Fed may find yet another reason to delay normalizing interest rates.

Key Insights Gained From Q&A

March Hike

Yellen was asked directly about a March rate hike. Her response stuck very closely to script, repeating the sentiment from the prepared remarks for the testimony and

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adding that she cannot state exactly at what meeting the next rate hike would take place (March, May or June), but that **"every meeting is live."**

Fiscal Policy and Economic Forecasts
Yellen said that the Committee has not fully incorporated the impact of possible fiscal policy changes into its economic forecasts, as it prefers to wait for concrete policy details. The Fed is in a tough spot. It is understandable that the Fed would rather wait than speculate. But at the same time, it runs the risks of waiting too long to adjust its expectations for the economic outlook and monetary policy response, increasing the likelihood of falling behind the curve and having to adjust policy at a much faster pace than currently expected and shocking financial markets. This is another issue that makes a March rate hike attractive.

Wage Growth and Productivity
Yellen noted that low productivity has held down wage growth. Wages have picked up gradually, but very slowly in light of the sub-5% unemployment rate. The Fed will watch wage inflation closely for signs of broader inflationary pressures **and an overheating economy. Indeed Yellen said that "we have to make sure we do not allow conditions to get so tight that we push inflation above our 2% objective and we will be attentive."** Note that if fiscal and regulatory reforms spur business investment and increase productive capacity in US, wage gains would accelerate, particularly in light of the current insufficient supply of skilled labor in a growing array of industries.

Balance Sheet Policy
Yellen indicated that the Fed will discuss its balance sheet policy in coming months. She said that the Committee wants a smaller balance sheet and wants it to eventually consist primarily of treasury securities (as opposed to mortgage back securities) and ultimately wants policy to rely solely on policy rates. From the current situation in which the Fed is the largest holder of US treasuries and mortgage-backed securities, the issue of when the Fed decides to reduce or cease reinvesting maturing assets in its portfolio is a very touchy one for financial markets--and for the Fed which is scared that a negative market response may harm the housing market or otherwise damage the economy.

Yellen refrained from stating exactly when the Fed intends to stop reinvestment of securities, but said the Fed wants to do it when interest rate normalization is well under way. If the economy strengthens in response to fiscal reform, allowing the balance sheet to shrink will mitigate how much the Fed has to raise rates.

Financial Choice Act
There were a number of questions about financial industry regulation--**not surprising in light of President Trump's** Executive Order to review the financial regulatory structure and pending bank regulation legislation like the House Financial Choice Act.

Resilience of Financial System and Stress Tests
Yellen spoke in favor of the financial regulations implemented since the crisis stating that measures including stress tests and the Consumer Financial Protection Bureau have made the financial system and economy stronger. The House Financial Choice Act will seek to modify the CFPB.

Ease of Regulations for Regional and Smaller Banks
Some Republican Senators expressed concerned about the excessive regulations on small and regional banks since the implementation of Dodd Frank. Yellen said the Fed is committed to reducing regulatory burden on small banks after a Senator pointed out that small banks' footprint on economy has lessened since implementation of Dodd Frank. Expect Congress and the Trump administration to work towards easing the burden on small and regional banks in 2017. This is one key factor underlying expectations of faster lending by regional and small banks and stronger growth of business investment.

Rule-Based Monetary Policy
In response to a question about the Fed adopting a more rules-based conduct of monetary policy, Yellen responded that the Taylor Rule would currently point to short-term rate between 3.5-4%, much higher than the current values of the federal funds rate and would put lead to a much weaker economy. Yellen used this exaggerated response to emphasize her preference for continuing to rely on discretionary monetary policy.

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