FLORIDA PRIME

Weekly Commentary

JANUARY 31, 2011

Paige Wilhelm
Senior Vice President
Senior Portfolio Manager
Federated Investment Counseling

The past week continued the theme of the last two months: the economic news generally was better and low short rates were basically unchanged—positions Federal Reserve policymakers reinforced at the end of their two-day meeting on Wednesday. The policy-setting Federal Open Market Committee (FOMC) acknowledged the economy improved toward the end of 2010, but it continued to temper positives by also noting negatives. For example, while it said household spending picked up late last year, it also said it "remains constrained by high unemployment, modest income growth, lower housing wealth and tight credit." And while it said business spending on equipment and software is rising, it also said "investment in nonresidential structures is still weak."

The upshot: The Fed made clear that it is sticking with QE2—the $600 billion of intermediate to longer-term Treasury security purchases through June—and a federal funds target rate at "exceptionally low levels … for an extended period." Indeed, the FOMC reiterated almost precisely the language of its December 14 meeting, noting that underlying inflation continues to trend downward and is "somewhat low" relative to the Fed's dual mandate of fostering maximum employment and price stability. In effect, it made clear that until it sees significant increases in job growth and declines in the jobless rate, the monetary spigots will remain wide open.

In other news on the week, the Commerce Department's flash estimate of Gross Domestic Product for 2010's fourth-quarter came in at 3.2%, a few ticks below expectations. But the underlying story was bullish—consumer spending rose at its fastest pace since early 2006, real final sales (ex-inventories) rose at their fastest pace since 1984 and export-fueled trade contributed the most to GDP since 1980. Even the holdback to growth—shrinking inventories—was actually a positive as it reflected the inability of suppliers to build inventories fast enough to meet demand. In terms of future growth, that's a good problem to have.

Turmoil in the Middle East, particularly Egypt, did wreak havoc in the global markets Friday, pushing down longer Treasury yields on the flight-to-safety trade. But the movement wasn't dramatic as traders appeared to take a wait-and-see approach on the final outcome. The bigger question, of course, is when will the U.S. recovery—technically, it's now an expansion since GDP has recovered the ground lost during the recession—begin to impact inflation expectations and short rates? As with traders on Egypt, the answer, for now, is a waiting game.

G40461-18 (1/11)

Views are as of January 31, 2011, and are subject to change based on market conditions and other factors.