



## **DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS**

The Committee reviewed the most recent report on System Open Market Account holdings, dated January 20, 2016. Total domestic securities held in the SOMA stood at \$4,226.8 billion, comprising \$2,346.6 billion in Treasury notes and bonds and \$1,750.3 billion in agency mortgage-backed securities. This represented a decline of \$11.9 billion from the prior release of January 13, 2016. It was noted for the record that these figures cover SOMA securities holdings only — their total size, composition, and week-over-week change — and do not encompass the results of repo or reverse-repo operations, for which no point-in-time-safe data source currently exists; accordingly, no discussion of such operations is reflected here.

## **STAFF REVIEW OF THE ECONOMIC SITUATION**

The staff reported that inflation remained well short of the Committee's longer-run objective. Core PCE inflation was running at 1.26 percent on a twelve-month basis, some three-quarters of a percentage point below the 2 percent goal. Labor market conditions, by contrast, continued to look firm: the unemployment rate stood at 5.0 percent, essentially at the estimated natural rate of 5.04 percent, and initial jobless claims remained low at 284,000. The Employment Cost Index registered 124.5. Measures of real activity, however, pointed to below-trend momentum, with the Chicago Fed National Activity Index at -0.3. M2 money supply stood at \$12,330 billion.

The Beige Book material for the Second District described economic activity as having remained 'essentially flat' since the prior report, even as labor markets continued to be characterized as tight, with service-sector firms reporting upward pressure on input prices and wages. Selling prices were generally stable. Consumer spending was sluggish, and the holiday season was described as flat to down moderately from a year earlier, with one major retail chain reporting December sales below plan and below 2014 levels; weakness in New York City was attributed in part to weak tourism, and some softness in winter apparel to unseasonably mild weather. Tourism activity weakened further, with hotel and Broadway theater revenues down noticeably from a year earlier and upstate ski areas struggling with warm weather. Manufacturers reported that activity continued to weaken. Residential real estate conditions continued to improve while commercial real estate was little changed, and banks reported weaker household loan demand alongside lower delinquency rates, especially on residential mortgages. On a more positive note, a December survey showed regional consumer confidence rebounding sharply.

## **STAFF REVIEW OF THE FINANCIAL SITUATION**



Financial conditions showed signs of tightening and elevated volatility since the December liftoff. The VIX stood at 27.59, an elevated reading indicative of heightened market anxiety and risk aversion. The Baa corporate spread over Treasuries was 3.35, a meaningfully wide level pointing to rising borrowing-cost stress and greater compensation demanded for corporate credit risk. The broader financial stress index, at 0.132 on a zero-to-one scale, remained moderate rather than extreme. The yield curve was still positively sloped, with the 10-year/2-year spread at 1.16, so no recession signal was evident from an inversion. At the front end, the 3-month T-bill spread relative to the current target range was slightly negative at -0.115, suggesting that markets were not pricing near-term tightening and may have been leaning toward an easing bias.

### STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment drew on several quantities bearing directly on the likely path of conditions. The estimated neutral real rate ( $r^*$ ) was placed at -0.5 percent, implying that the neutral policy rate was very low and that the current 0.25 to 0.50 percent target range could be leaning modestly restrictive relative to that benchmark. Inflation momentum was estimated at 0.065, close to zero, consistent with the absence of any building upward price pressure that would argue for a more restrictive stance; unemployment momentum was -0.05, indicating that joblessness was not rising even as broader activity ran below trend.

The reference-rule outputs available to the staff were mutually reinforcing this meeting and were judged reliable. The Taylor rule, the Balanced Approach rule, the First-Difference rule, and the ELB-adjusted rule each pointed to -25 basis points, and the loss-minimizing recommendation likewise came in at -25 basis points. Taken together, these projections implied that, on a pure loss-minimization basis, the persistent shortfall of inflation below target combined with soft activity and a deeply negative neutral rate placed the optimal stance modestly below the current range — roughly one 25-basis-point step. The staff cautioned that these are model-based projections keyed to the inputs available and do not by themselves capture communication or timing considerations.

### PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their predictive discussion of the likely policy decision, all participants converged on holding the target range unchanged at 0.25 to 0.50 percent. Participants generally observed that liftoff had occurred only one meeting earlier, with guidance stressing that increases would be only gradual and data dependent, and that a second consecutive move so soon would sit uneasily with that framing. A common thread was that inflation gave no urgency to tighten: core PCE at 1.26 percent remained well below the 2 percent objective. At the same time, no participant saw a case for easing on the predictive read, given that the labor market was essentially at full employment — unemployment at 5.0 percent



against a 5.04 percent natural rate, and claims low at 284,000 — with no sign of the deterioration that would trigger the labor-focused member's concern.

Financial conditions figured prominently in the predictive discussion. The financial-stability member emphasized that the VIX at 27.59 and the Baa spread at 3.35 signaled meaningful volatility and credit-cost stress that had, in effect, tightened conditions beyond the Committee's policy intent, so that hiking into that environment risked destabilizing markets unnecessarily. The market-signal member read the slightly negative 3-month T-bill spread as a direct indication that markets were pricing no January hike and possibly an easing bias, reinforcing the case for a pause. The inflation-focused member noted that the strongest pro-hike argument — a tight labor market with some upward wage and input-price pressure in the Beige Book — did not override soft actual inflation and rising financial stress. Participants generally agreed that the softening in real activity described in the Beige Book, including weakening manufacturing, sluggish consumer spending, weak tourism, and a Chicago Fed index at -0.3, argued for patience rather than further action.

When the discussion turned to the deterministic framework's recommendation of -25 basis points — with all four reference rules in agreement and judged reliable — participants engaged the merits of easing rather than merely restating the hold. Several were persuaded that the case was genuine. The inflation-focused member acknowledged that, with inflation running persistently below target and momentum near zero, a hawkish bias simply did not bind, and that the estimated  $r^*$  of -0.5 percent suggested the current range might be modestly too tight; this member came to accept the -25 basis point call on the merits. The data-dependent member, reading the indicators at face value, likewise concluded that sub-target inflation, activity described as flat, and a negative neutral rate literally supported easing, and treated the reluctance to reverse December's hike as a communication concern rather than a data signal. The financial-stability member, weighing the wide Baa spread as tightening that was doing the Committee's work independent of the policy rate, also endorsed the direction and magnitude, judging that no participant had shown a cut would destabilize conditions more than the credit stress itself.

Two participants agreed with the direction of the framework's recommendation but were not prepared to endorse its full magnitude or timing. The labor-focused member supported easing as cheap insurance for employment given below-trend growth and tightening credit, but flagged that unemployment sat at its natural rate with no actual labor deterioration, and worried that a full reversal one meeting after the first hike would be abrupt — expressing a preference for a smaller, less jarring step. The market-signal member similarly read the front-end pricing and elevated VIX as showing pressure toward easing but 'not a scream for it,' cautioning that the volatility could prove transitory and



that reversing course in a single step so soon after liftoff risked a confidence shock the market signals did not yet demand. For these members the divergence was one of speed and size, not direction.

Across both strands of the discussion, participants broadly shared a reading of the balance of risks: financial conditions had tightened since December, inflation remained soft with little momentum, the labor market was near balance with no rising joblessness, and the positive yield curve gave no recession signal. The tension that emerged was between the framework's loss-minimizing logic — which, anchored on the inflation shortfall and a negative neutral rate, pointed to a modest easing — and the practical caution of moving again so soon after the first increase in years. Participants generally characterized the gap between the current stance and the model-optimal stance as roughly one 25-basis-point step: meaningful, but indicating that policy was near rather than far from optimal.

#### **COMMITTEE POLICY ACTIONS**

On the predictive question of the policy decision, all five members forecast that the Committee would hold the target range unchanged at 0.25 to 0.50 percent, a unanimous 5-to-0 read. On the separate question of the deterministic framework's -25 basis point recommendation, the Committee did not divide on direction: three members — the inflation-focused member, the financial-stability member, and the data-dependent member — endorsed the recommendation as-is, while two members — the labor-focused member and the market-signal member — offered partial support, agreeing with the easing direction but not with its full magnitude or timing. No member declined the recommendation outright.