U.S. NEWS

Yellen Debut Rattles Markets

Wary Investors Seize on New Fed Chief's Mixed Message on Pace of Rate Increases

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At a news conference, Federal Reserve Chairwoman discusses why the Fed moved to alter its guidance on interest rates. Photo: AP.

Investors bristled after Janet Yellen emerged from her first meeting as Federal Reserve chairwoman with some unsettling signals about the central bank's outlook for short-term interest rates.

The Fed intends to keep short-term rates near zero into next year, but investors sniffed out signs that rate increases might come a bit sooner and be a touch more aggressive than expected. Even though the Fed's official policy statement sought to give assurances of continued low rates far into the future and Ms. Yellen played down rate-increase expectations, stock prices fell and longer-term rates on Treasury bonds moved up.

In a press conference after the meeting, Ms. Yellen suggested that interest-rate increases might come about six months after the bond-buying program ends—a conclusion that could come this fall. She offered that projection with many caveats, but some investors took it as a sign that the Fed could start raising interest rates sooner than expected.

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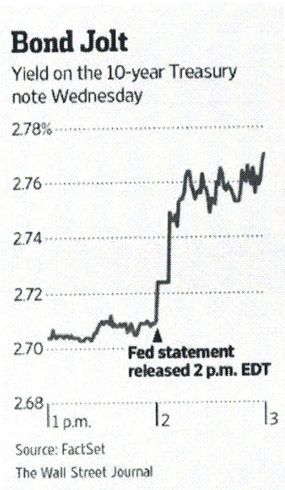
"This could have been a rookie gaffe on Yellen's part," Paul Edelstein, director of financial economists at IHS Global Insight, said in a note to clients. "This was, after all, her first press conference."

In futures markets, prices indicated investors' expected rate for the Fed's benchmark federal funds rate for June 2015 moved up from 0.28% before the Fed's meeting to 0.36% after the meeting.



The market response was emblematic of the market's hypersensitivity to the Fed's interest-rate decisions after seven years of aggressive central-bank action to stabilize and strengthen the economy.

It is also emblematic of the challenge Ms. Yellen faces as she takes charge at the Fed. As the economy gets on a stronger footing, the Fed is gradually stepping back from its easy-money stance, but if it moves back too quickly, it could undercut the recovery it has been working to support.

"We will try as hard as we can not to be a source of instability here," Ms. Yellen said in response to a question about the Fed's communications in her first postmeeting press conference since taking the Fed's helm last month.

The Dow Jones Industrial Average finished down 114.02 points, or 0.7%, at 16222.17. Yields on 10-year Treasury notes rose 0.096 percentage point to 2.770%.

"It just tells you how nervous bond investors are on rising rates," said Gary Pollack, who helps oversee $12 billion as head of fixed-income trading in New York at Deutsche Bank AG's private wealth management unit.

At her first press conference as Federal Reserve Chairwoman, Janet Yellen is asked how long before the Fed increases interest rates as it winds down its bond-buying program. Photo: Associated Press

The Fed took several actions at the meeting. First, it pulled back to $55 billion from $65 billion its monthly bond-buying program, which is aimed at holding down long-term interest rates in hopes of boosting spending, hiring and growth. It was the third reduction in the bond purchases since December.

The central bank also rewrote its guidance about the likely path of short-term interest rates, putting less weight on the unemployment rate as a signpost for when rate increases will start. It said instead that the Fed would look at a broad range of economic indicators in deciding when to start raising short-term rates from near zero, where they have been since December 2008.

The Fed has been linking its interest-rate decisions since December 2012 to the path of the unemployment rate, saying it wouldn't even consider interest-rate increases as long as the jobless rate was above 6.5%. With the unemployment rate approaching that threshold—it was 6.7% in February—the Fed set out new guidelines for the interest-rate outlook.

The Fed said it would be watching a "wide range of information," including measures of job market conditions, inflation and financial market developments. Ms. Yellen mentioned 10 different labor-market indicators she is watching, including the share of workers who have been unemployed for six months or more, the share of adults who are holding or seeking jobs, the portion of workers who hold part-time jobs but say they would rather have full-time occupations and the rate at which

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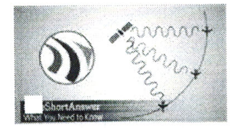

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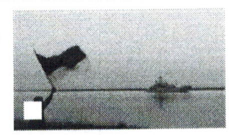

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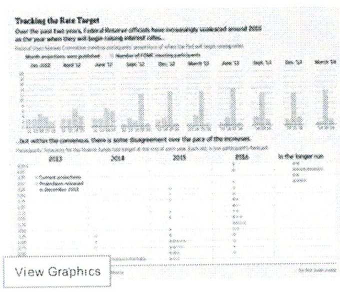
people are quitting jobs.

The Fed took several steps to assure investors that interest rates won't rise soon and that when rates do start rising the increases will be gradual and limited. For example, the Fed's official policy statement included a new line noting that officials expect to keep rates lower than normal even after inflation and employment return to their longer-run trends.



"Economic conditions may, for some time, warrant keeping the target federal funds rate below levels the [Fed] views as normal in the longer run," the Fed said in its policy statement.

In normal times, the fed funds rate is around 4%. Because of various factors weighing on growth, the Fed's official policy statement indicated the fed funds rate isn't likely to return to that 4% level in the foreseeable future.

However, investors seized on some signs that the Fed was expecting slightly more aggressive interest-rate increases than it was a few months ago. For instance, as a supplement to its official policy statement, the Fed released new economic projections by the 16 officials who attended the policy meeting. The median projection for short-term rates at the end of 2015—meaning half of projections were above and half were below—was 1%. That is a small increase from a 0.75% median estimate in December. The median for 2016 moved from 1.75% to 2.25%.

Ms. Yellen played down the shifting projections. "These dots are going to move up and down," she said of the interest-rate projections, adding that the policy statement was a more important guide to the Fed's plans.

That policy statement said the Fed's stance on interest rates hadn't changed. Still, some analysts took a different message.

"It is the clearest sign yet," Harm Bandholz, chief U.S. economist with UniCredit Research, said in a note to clients, "that the tendency for later and later rate hikes that dominated over the past couple of years might have come to an end."

Federal Reserve chairwoman Janet Yellen's opening remarks on the Fed's statement and decision to make a reduction in the pace of its purchases of longer term securities and its move to alter its guidance on the likely path of interest rates. Photo: Getty Images.

Investors got a somewhat mixed message on the economy. Ms. Yellen acknowledged that officials might have been too optimistic about the economic outlook early in the year. But she and other officials largely stuck to their projections for how growth and inflation will unfold in the coming years.

Fed officials see inflation slowly returning from nearly 1% recently to 2% in the years ahead and the economy reaching a growth rate around 3% or a little less. They reduced their estimates for the unemployment rate, which they see falling to between 6.1% and 6.3% by year-end, from 6.7% in February. They attributed recent sluggishness in growth in part to "adverse weather conditions."

Officials, however, remain deeply worried about longer-running headwinds to the economy. Ms. Yellen said these headwinds include many households' limited access to credit because of tarnished credit histories and homes that are worth less than their mortgages. She said some Fed officials also see the recovery weighed down by

WSJ Chief Economics Correspondent Jon Hilsenrath discusses the Federal Reserve's move to alter its guidance on the likely path of interest rates, putting less weight on the unemployment rate as a sign for when rate increases will start. Photo: Getty.

weakness in the global economy, restrictive U.S. tax and spending policies and persistent business caution.

"We've lived through a devastating financial crisis that has taken an exceptional toll on the economy in many ways," she said.

Ms. Yellen faced one dissent in her first meeting, that of Minneapolis Fed President Narayana Kocherlakota. He has been a strong proponent of offering assurances that the Fed will keep rates low until the jobless rate gets much lower. He believed the shift away from such guideposts hurt the Fed's credibility and "fosters policy uncertainty," according to the Fed's policy statement.

—Alexandra Scaggs contributed to this article.

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