

Economic Analysis

July FOMC Minutes: Worries of Overshooting Economic Goals in Medium-Term

Kim Fraser Chase

The FOMC continued its delicate balancing act of transparent and clear communication, while preserving the flexibility to remain data-driven. The July minutes reveal a tentative plan on policy normalization that most participants agree upon. At the same time, the minutes did not provide any new details on the exit strategy, communicating only general outline to the exit strategy approach. Meanwhile, in light of the importance to communicate a clear plan regarding the details on normalization, the FOMC committed to provide additional information to the public “later this year” and “well before most participants anticipate the first steps in reducing policy accommodation to become appropriate.” Overall, meeting participants were also in agreement regarding the approaches to normalize the size and composition of balance sheet, with only a few participants dissenting in favor of tighter policy with faster balance reduction. In general, most of the participants agreed that the size of the balance sheet should be reduced gradually and predictably, and that in the long run, the balance sheet should consist primarily of Treasury securities and reduced to the “smallest level consistent with efficient implementation of monetary policy.” Additionally, most participants continued to anticipate that the sale of mortgage-backed securities (MBS) would occur only to eliminate residual holdings.

The unexpected highlight of the minutes was the Committee’s assessment of medium-term economic projections which revealed many FOMC participants’ worries over possibility of quicker than anticipated convergence of economic outlook toward the FOMC goals. Likewise, this can prompt earlier than expected removal of accommodative policy. We continue to expect the end to tapering in 4Q14, with the first rate hike occurring in mid-2015. Likewise, we expect that the Fed will continue to adjust policy plans dependent on incoming data. Despite many participants’ concerns over overshooting economic objectives in medium-term, FOMC was vastly in agreement that any change in the expectations regarding the first rate increase and the overall trajectory of federal fund rate would depend on further projections of economic activity, the labor market and inflation. For more details, see our latest [Fed Watch](#).

Inflation Decelerates in July alongside Decline in Energy Prices

The consumer price index increased a modest 0.1% in July following four consecutive months of at least 0.2% growth. Energy prices were the major driver, declining 0.3% for the month and mostly offsetting a 0.4% gain in food prices. Excluding food and energy, core inflation increased 0.1% for the second straight month, noting particular acceleration in shelter prices. On a YoY basis, headline and core CPI declined to 2.0% and 1.85%, respectively, holding below the Fed’s inflation target. We do not expect that this data will have any impact on the expected 4Q14 end to QE3, though the report does lend its support to the dovish views in the FOMC when it comes to planning for the first federal funds rate hike next year. Another few months of slow inflation will help push off the hawks and keep the Fed on track for a mid-2015 rate hike. Ultimately, we expect CPI inflation to remain near 2.0% or below throughout the second half of 2014, averaging 1.9% for the year and accelerating to 2.2% in 2015.

Week Ahead

S&P Case-Shiller House Price Index (June, Tuesday 9:00 ET)

Forecast: 9.00%

Consensus: 8.24%

Previous: 9.34%

Home prices have been hindering activity in the housing market throughout the past few months, but the slowing demand appears to be finally put some downward pressure on inflation. According to the S&P Case-Shiller 20-city composite index, home prices declined on a monthly basis in May for the first time since January 2012. Furthermore, YoY prices dropped to single-digit growth following more than a year of double-digit gains. The latest home price indicators for June suggest a modest rebound in prices for the month, but we continue to expect YoY deceleration for the foreseeable future.

Consumer Confidence (August, Tuesday 10:00 ET)

Forecast: 89.50

Consensus: 88.50

Previous: 90.90

Consumer confidence has been on the rise since April but we expect that the index will take a minor step back in August. Other confidence indicators have shown some hesitation from consumers so far this month, with the University of Michigan's consumer sentiment index continuing a downward trend throughout the first few weeks of August. Most of this weakness stems from consumer expectations, even though the labor market outlook appears to have improved. Views on current conditions have continued to improve as gas prices remain steady or in decline. Thus, we expect that slightly more pessimistic expectations may offset any gains in the short-term views, ultimately dragging down the consumer confidence index for the month.

GDP, Preliminary (2Q14, Thursday 8:30 ET)

Forecast: 3.5%

Consensus: 3.9%

Previous: 4.0%

The second estimate for 2Q14 real GDP growth is expected to show a slight downward revision. Economic data released since the initial figure suggest some offsetting trends but all in all we expect the results to put downward pressure on this revision. On the positive side, monthly changes in personal consumption expenditures and industrial production were revised up slightly for May and June, respectively. Construction spending was also revised up for May, but the subsequent report for June was extremely negative and does not point to much improvement for residential investment. The minor downward revision to the trade balance in May could also weigh on growth in 2Q. Data on inventory growth, which has been a big factor in recent GDP reports, were mostly unchanged since the initial estimate and therefore should have little impact on this revision.

Personal Income and Outlays (July, Friday 8:30 ET)

Forecast: 0.2%, 0.3%

Consensus: 0.3%, 0.1%

Previous: 0.4%, 0.4%

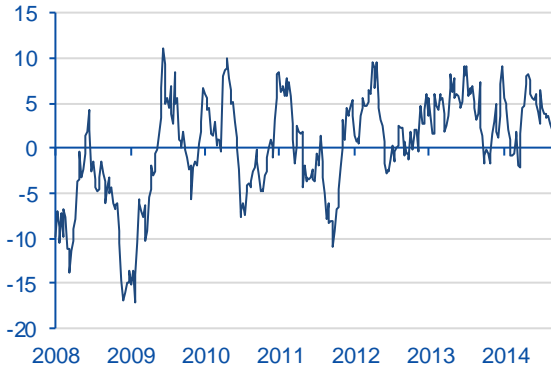
Personal income and outlays are expected to decelerate in July but remain relatively healthy moving into the second half of the year. Income growth has held steady at 0.4% for the past three months while consumption has gained traction, but the latest data suggest a minor slowdown for both components. Inflation took a step back in July, likely weighing on the nominal figures but suggesting that the impact on real consumption and GDP will be minimal.

Market Impact

Markets this week may be hypersensitive to economic data as they continue to digest the FOMC meeting minutes. GDP and consumption stand out as the major indicators, but we could also see some reaction to home prices if the data hint at increased headwinds for the housing market.

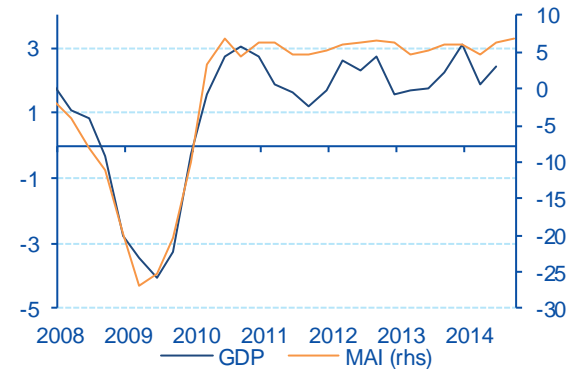
Economic Trends

Graph 3
BBVA US Weekly Activity Index (3 month % change)



Source: BBVA Research

Graph 4
BBVA US Monthly Activity Index & Real GDP (4Q % change)



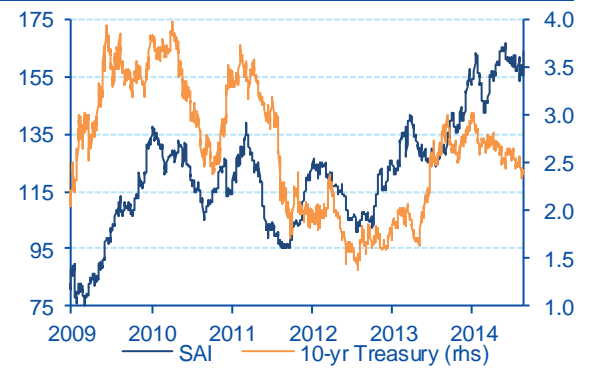
Source: BBVA Research & BEA

Graph 5
BBVA US Surprise Inflation Index (Index 2009=100)



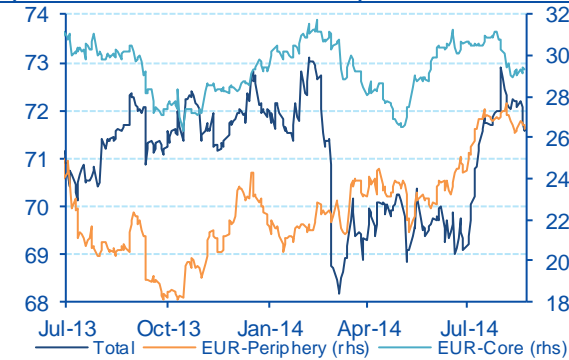
Source: BBVA Research

Graph 6
BBVA US Surprise Activity Index & 10-yr Treasury (Index 2009=100 & %)



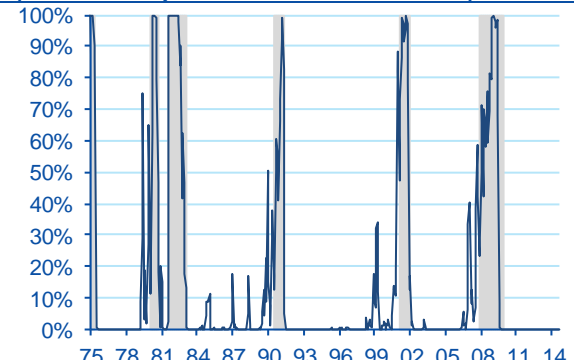
Source: Bloomberg & BBVA Research

Graph 7
Equity Spillover Impact on US (% Real Return Co-Movements)



Source: BBVA Research

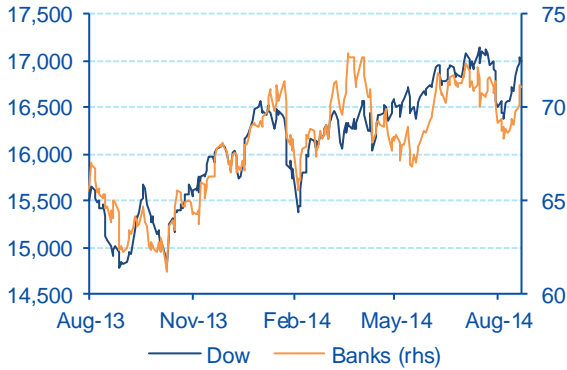
Graph 8
BBVA US Recession Probability Model (Recession episodes in shaded areas, %)



Source: BBVA Research

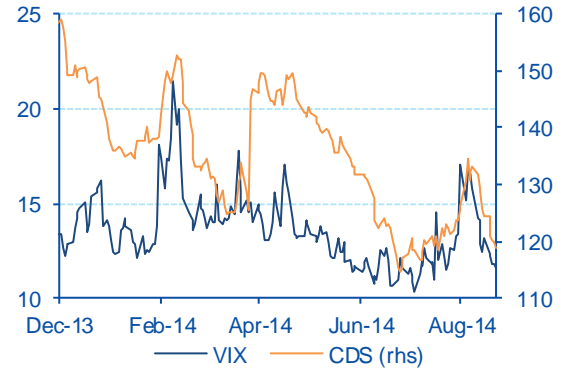
Financial Markets

Graph 9
Stocks
(Index, KBW)



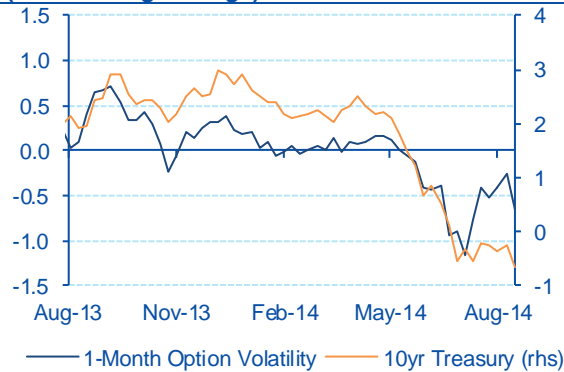
Source: Bloomberg & BBVA Research

Graph 10
Volatility & High-Volatility CDS
(Indices)



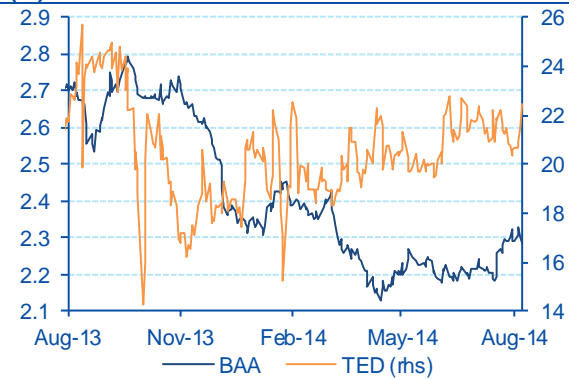
Source: Bloomberg & BBVA Research

Graph 11
Option Volatility & Real Treasury
(52-week avg. change)



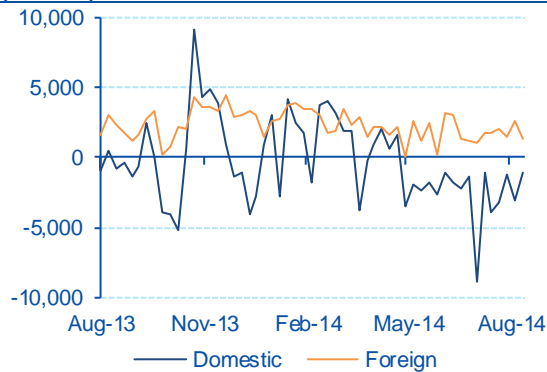
Source: Haver Analytics & BBVA Research

Graph 12
TED & BAA Spreads
(%)



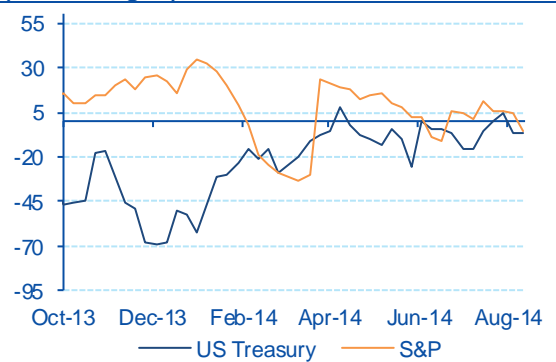
Source: Bloomberg & BBVA Research

Graph 13
Long-Term Mutual Fund Flows
(US\$Mn)



Source: Haver Analytics & BBVA Research

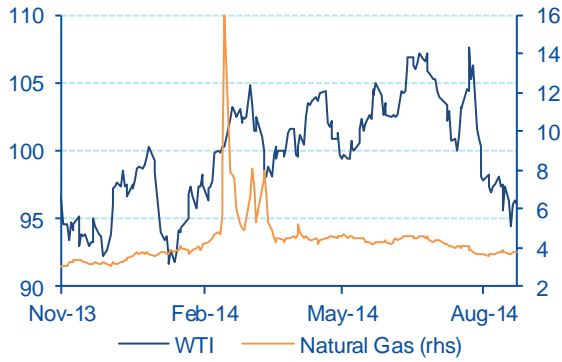
Graph 14
Total Reportable Short & Long Positions
(Short-Long, K)



Source: Haver Analytics & BBVA Research

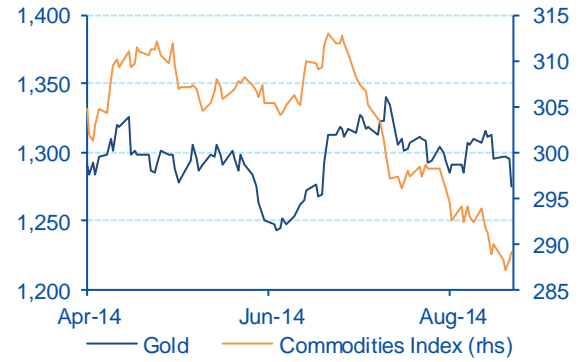
Financial Markets

Graph 15
Commodities
(Dpb & DpMMBtu)



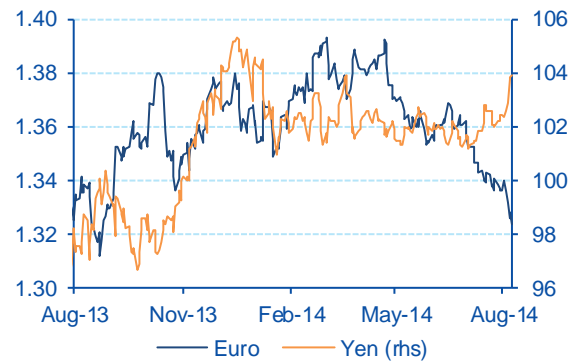
Source: Bloomberg & BBVA Research

Graph 16
Gold & Commodities
(US\$ & Index)



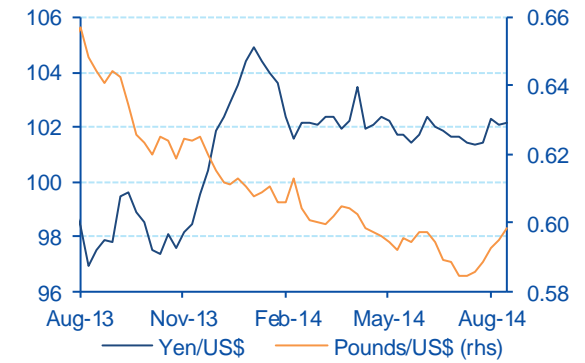
Source: Haver Analytics & BBVA Research

Graph 17
Currencies
(Dpe & Ypd)



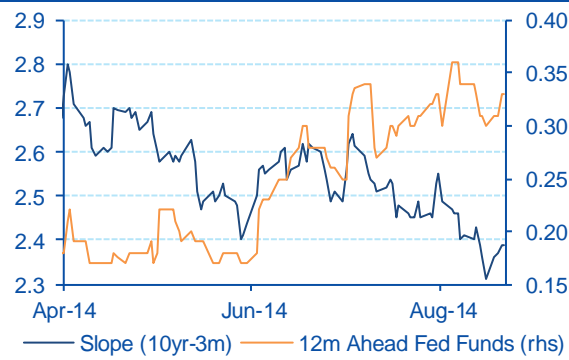
Source: Bloomberg & BBVA Research

Graph 18
6-Month Forward Exchange Rates
(Yen & Pound / US\$)



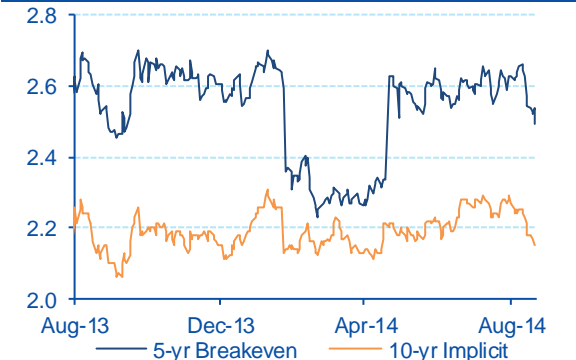
Source: Haver Analytics & BBVA Research

Graph 19
Fed Futures & Yield Curve Slope
(% & 10year-3month)



Source: Haver Analytics & BBVA Research

Graph 20
Inflation Expectations
(%)



Source: Bloomberg & BBVA Research

Interest Rates

Table 1
Key Interest Rates (%)

	Last	Week ago	4-Weeks ago	Year ago
Prime Rate	3.25	3.25	3.25	3.25
Credit Card (variable)	14.86	14.86	14.86	14.10
New Auto (36-months)	2.92	2.91	2.90	2.39
Heloc Loan 30K	4.97	4.94	4.97	5.35
5/1 ARM *	2.95	2.97	2.99	2.90
15-year Fixed Mortgage *	3.23	3.24	3.26	3.23
30-year Fixed Mortgage *	4.10	4.12	4.13	3.99
Money Market	0.39	0.38	0.40	0.44
2-year CD	0.85	0.85	0.82	0.75

*Freddie Mac National Mortgage Homeowner Commitment US
Source: Bloomberg & BBVA Research

Table 2
Key Interest Rates (%)

	Last	Week ago	4-Weeks ago	Year ago
1M Fed	0.09	0.09	0.09	0.08
3M Libor	0.23	0.23	0.23	0.26
6M Libor	0.33	0.33	0.32	0.39
12M Libor	0.56	0.56	0.55	0.67
2yr Sw ap	0.72	0.63	0.69	0.54
5yr Sw ap	1.81	1.70	1.80	1.71
10Yr Sw ap	2.55	2.49	2.59	2.90
30yr Sw ap	3.14	3.11	3.20	3.69
30day CP	0.12	0.12	0.11	0.12
60day CP	0.13	0.11	0.11	0.15
90day CP	0.14	0.13	0.13	0.16

Source: Bloomberg & BBVA Research

Quote of the Week

Janet L. Yellen, Federal Reserve Chair

Labor Market Dynamics and Monetary Policy, Jackson Hole, Wyoming

22 August 2014

“As a consequence, monetary policy ultimately must be conducted in a pragmatic manner that relies not on any particular indicator or model, but instead reflects an ongoing assessment of a wide range of information in the context of our ever-evolving understanding of the economy.”

Economic Calendar

Date	Event	Period	Forecast	Survey	Previous
25-Aug	Chicago Fed National Activity Index	JUL	0.25	0.20	0.12
25-Aug	US New One Family Houses Sold Annual Total SAAR	JUL	425.00	430.00	406.00
25-Aug	US New One Family Houses Sold Annual Total MoM SA	JUL	4.68	5.91	-8.10
25-Aug	Dallas Fed Manufacturing Outlook Level Of General Business Activity	AUG	14.10	12.75	12.70
26-Aug	US Durable Goods New Orders Industries MoM SA	JUL	1.10	7.60	1.70
26-Aug	US Durable Goods New Orders Total ex Transportation MoM SA	JUL	1.00	0.50	1.90
26-Aug	S&P/Case-Shiller Composite-20 City Home Price Index SA MOM % Change	JUN	0.60	0.00	-0.31
26-Aug	S&P/Case-Shiller Composite-20 City Home Price Index YoY	JUN	9.00	8.24	9.34
26-Aug	Conference Board Consumer Confidence SA 1985=100	AUG	89.50	88.50	90.90
28-Aug	US Initial Jobless Claims SA	AUG 23	300.00	300.00	298.00
28-Aug	US Continuing Jobless Claims SA	AUG 16	2515.00	2500.00	2500.00
28-Aug	GDP US Chained 2009 Dollars QoQ SAAR	2Q S	3.50	3.90	4.00
28-Aug	GDP US Personal Consumption Chained 2009 Dirs % Change from Previous Period SAAR	2Q S	2.50	2.40	2.50
28-Aug	US GDP Price Index QoQ SAAR	2Q S	2.00	2.00	2.00
28-Aug	US GDP Personal Consumption Core Price Index QoQ % SAAR	2Q S	2.00	2.00	2.00
28-Aug	US Pending Home Sales Index MoM SA	JUL	0.70	0.50	-1.06
29-Aug	US Personal Income MoM SA	JUL	0.20	0.30	0.40
29-Aug	US Personal Consumption Expenditures Nominal Dollars MoM SA	JUL	0.30	0.10	0.40
29-Aug	MNI Chicago Business Barometer (sa)	AUG	54.50	56.50	52.60
29-Aug	University of Michigan Survey of Consumer Confidence Sentiment	AUG F	80.30	80.15	79.20

Forecasts

	2011	2012	2013	2014	2015	2016	2017
Real GDP (% SAAR)	1.8	2.8	1.9	2.0	2.5	2.8	2.8
CPI (YoY %)	3.1	2.1	1.5	1.9	2.2	2.3	2.4
CPI Core (YoY %)	1.7	2.1	1.8	2.0	2.1	2.3	2.4
Unemployment Rate (%)	8.9	8.1	7.4	6.3	5.9	5.8	5.5
Fed Target Rate (eop, %)	0.25	0.25	0.25	0.25	0.50	1.50	2.50
10Yr Treasury (eop, % Yield)	1.98	1.72	2.90	3.00	3.50	3.75	4.00
US Dollar/ Euro (eop)	1.31	1.31	1.37	1.31	1.29	1.36	1.36

DISCLAIMER

This document was prepared by Banco Bilbao Vizcaya Argentaria's (BBVA) BBVA Research U.S. on behalf of itself and its affiliated companies (each BBVA Group Company) for distribution in the United States and the rest of the world and is provided for information purposes only. Within the US, BBVA operates primarily through its subsidiary Compass Bank. The information, opinions, estimates and forecasts contained herein refer to the specific date and are subject to changes without notice due to market fluctuations. The information, opinions, estimates and forecasts contained in this document have been gathered or obtained from public sources, believed to be correct by the Company concerning their accuracy, completeness, and/or correctness. This document is not an offer to sell or a solicitation to acquire or dispose of an interest in securities.