Central Banks

FOMC Statement: March 17th – 18th

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FOMC Drops “Patient”, First Rate Hike Unlikely in April

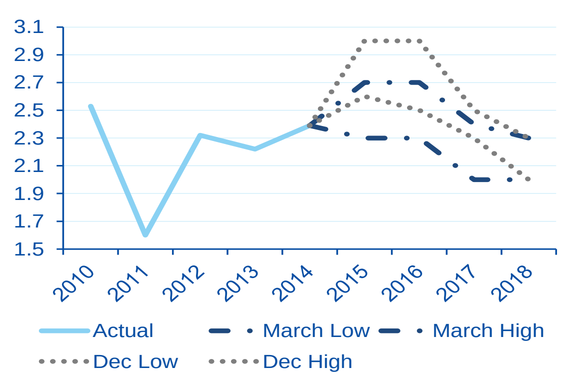
- **The FOMC removed “patient” but ensured that no decision has been made on timing**
- **Revised projections hint at more pessimistic growth outlook and slower pace of rate hikes**
- **Our expectations remain for the first rate hike in September, closing out 2015 at 0.5%**

The March FOMC announcement lived up to expectations, with the Committee removing the “patient” language from the statement. To help clarify this change to the forward guidance, the FOMC added to the statement that “an increase in the target range for the federal funds rate remains unlikely at the April FOMC meeting.” Furthermore, the statement noted that despite this change, the Committee is not necessarily closer to an agreement on the timing of the first rate hike. Yellen also emphasized in her press conference that removing the word “doesn’t mean we are going to be impatient.”

Outside of the forward guidance adjustment, the FOMC statement highlighted an important shift in the economic outlook. As expected, the Committee acknowledged that economic activity has “moderated somewhat” in the first quarter, highlighting export growth as another weakness on top of the slow recovery in the housing sector. When it comes to inflation, the statement suggests that the FOMC no longer expects inflation to decline but rather will remain near current low levels in the short term.

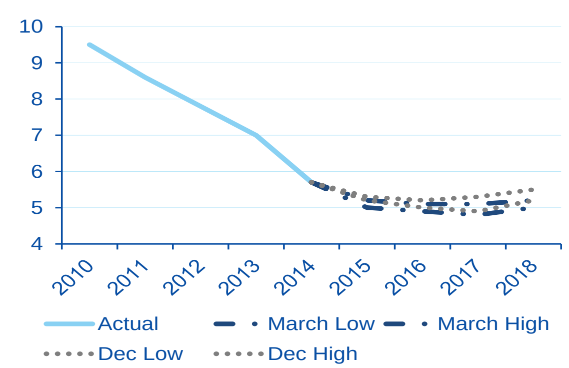
The FOMC’s revised projections confirm the views documented in the statement. Compared to December’s Summary of Economic Projections, FOMC members lowered expectations for the change in real GDP for 2015 through 2017. In particular, the downward revision to 2015 growth (from 2.6-3.0% to 2.3-2.7%) suggests a very weak first quarter. Although long-run projections remained steady, revisions were significant for 2016 and 2017. This is a notable change in the outlook and hints at increased uncertainty for growth outside of the weakness in economic data seen in the short-term.

Chart 1
Change in Real GDP, 4Q % Change (Central Tendency)



Source: Federal Reserve & BBVA Research

Chart 2
Unemployment Rate, 4Q % (Central Tendency)

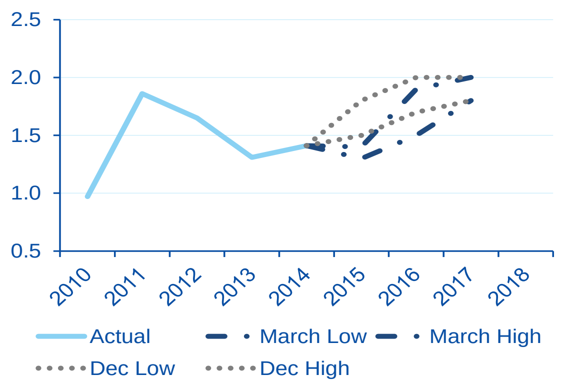


Source: Federal Reserve & BBVA Research

Unemployment and inflation projections were also revised down. Not surprisingly, FOMC members adjusted their projections for the faster-than-expected declines in the unemployment rate and the lower-than-expected inflation seen throughout the past few months. The unemployment rate was shifted down throughout the forecast horizon, with the central tendency in 2017 dropping from 4.9-5.3% to 4.8-5.1%. Although we have not seen much pass through to core inflation, the Committee brought down their projections for core PCE in 2015 and 2016. The revised forecasts suggest that they do not expect inflation to reach their target until at least 2017.

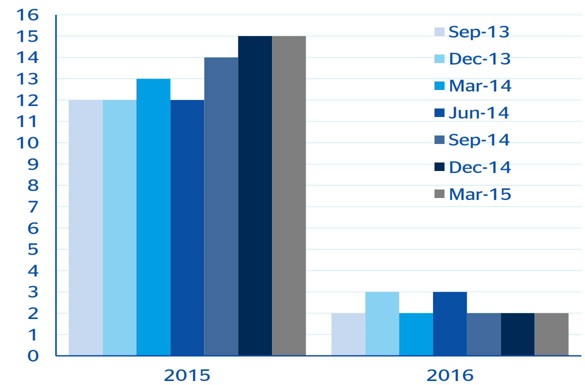
Finally, the expected path of the federal funds rate over the coming years appears more pessimistic now than it was in December. The most hawkish members seem to have shifted down their year-end projections, with the majority of FOMC participants expecting 0.5-1.0% in 2015 and 1.5-2.5% in 2016. The average long-run target rate declined from 3.78% to 3.66% in the past three months.

Chart 3
Core PCE Inflation, 4Q % Change (Central Tendency)



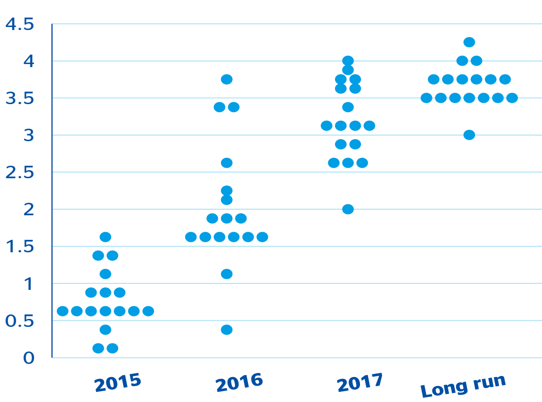
Source: Federal Reserve & BBVA Research

Chart 4
Appropriate Timing of Policy Firming (Number of Participants)



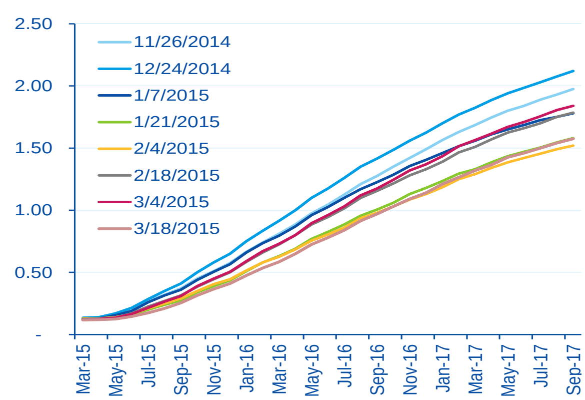
Source: Federal Reserve & BBVA Research

Chart 5
Target Federal Funds Rate Forecast (Year-end %)



Source: Federal Reserve & BBVA Research

Chart 6
Federal Funds Rate Futures (%)



Source: Bloomberg & BBVA Research

Yellen's press conference not only clarified the meaning of removing "patient" but also re-emphasized the need for data dependent policy moving forward. The Fed Chair noted that there is "no simple answer" and that the

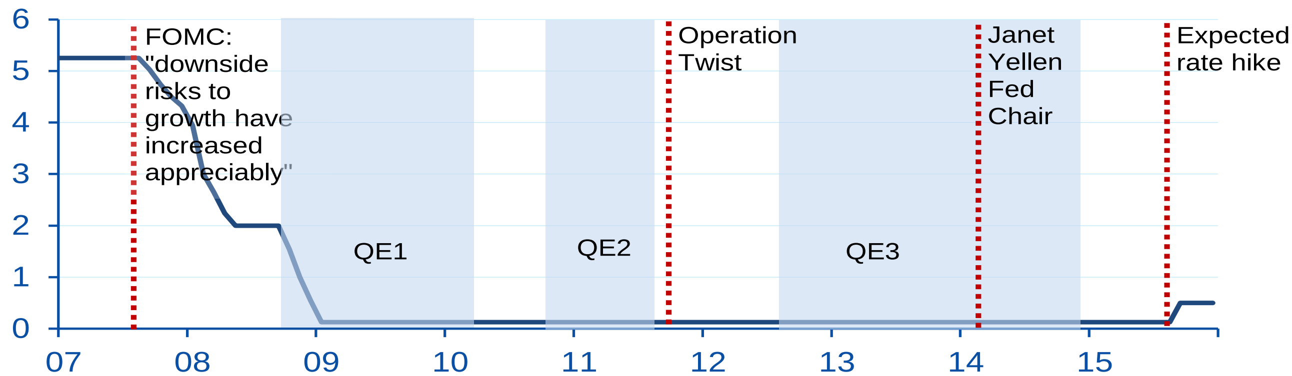
Committee will have to continue to make judgments based on incoming data. When asked why the Fed doesn't resort back to quantitative metrics, Yellen argued that "we can't provide certainty because economic developments that unfold are uncertain." The Committee wants to see that the economy is on a trajectory that warrants movement toward their 2% inflation objective, and they are still looking for further improvement in the labor market. Overall, Yellen suggested that most of her FOMC colleagues are in agreement that it will be appropriate to raise rates sometime this year in order to avoid being "behind the curve."

Market reaction to the statement was more enthusiastic than expected. The S&P 500 and Down Jones both jumped as soon as the statement was released, closing out the day just below record highs reached a few weeks ago. Demand for the 10-year Treasury increased, with the yield dropping to 1.9%, its lowest point since early February. The statement also influenced a decline in the USD as global markets eased concerns over an immediate rate hike.

Bottom Line: FOMC No Closer to a Decision on the First Rate Hike

The Fed moved one step closer to signaling the first rate hike, removing "patient" from their forward guidance with the hopes that markets would not see this as bias towards the June meeting. However, markets do not have the best track record when it comes to interpreting FOMC communication, and if history has taught us anything, it is to tread wisely. It's crunch time for the FOMC, and we are likely to see month-to-month changes in the statement language from this point forward as the first rate hike approaches. April's meeting will require more specific language to foreshadow whether or not a rate hike is expected to come in June. However, in line with the 1Q15 slowdown in economic activity, March's FOMC statement supports our baseline expectations for the first federal funds rate hike in September 2015.

Chart 7
Federal Funds Target Rate
(%)



Source: Federal Reserve & BBVA Research

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