RESEARCH

U.S. Fed Watch
06.17.2015

Central Banks

FOMC Statement: June 16th – 17th

Kim Fraser Chase

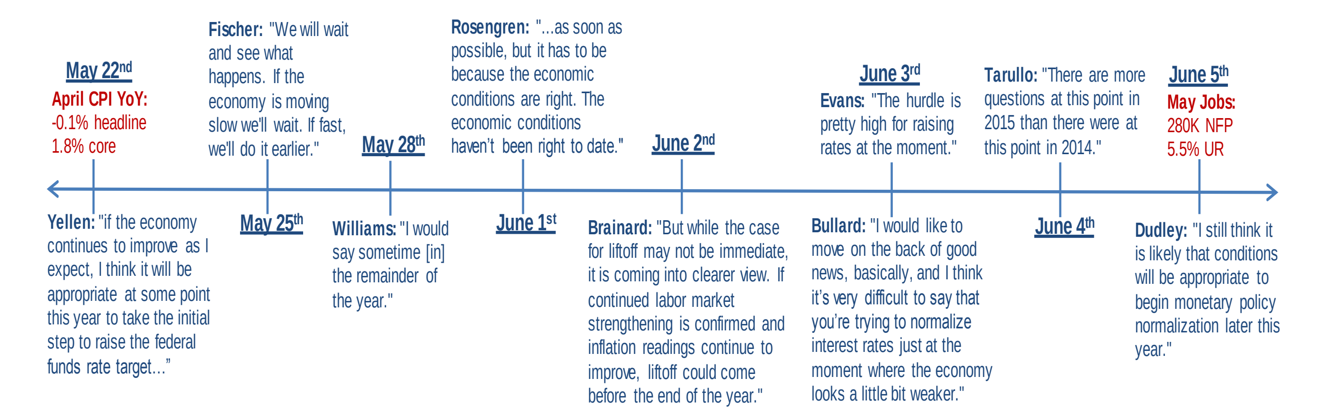
Time to Focus on the Future Rate Trajectory Rather than the First Hike

- **FOMC continues to delay first rate hike but signals that liftoff is likely sometime in 2015**
- **Revised projections hint at more pessimistic growth in 2015 and slower pace of rate hikes**
- **Our expectations remain for the first rate hike in September, closing out 2015 at 0.5%**

The long-awaited June FOMC meeting has come and gone, and with few surprises. FOMC members voted unanimously on withholding the first federal funds rate increase until further notice, dependent of course on whether or not the economy progresses in line with their expectations throughout the coming months. According to Yellen, the reasoning behind this move (or lack thereof) was due to the fact that based on their economic outlook, “conditions have not yet been achieved.” The probability for a June rate hike had dropped significantly since late 2014 alongside weak 1Q15 data and a slow start to 2Q15. However, leading up to the June meeting, most FOMC members had remained cautiously optimistic that a rate increase would happen sometime this year. Unfortunately, recent Fedspeak gave no clarity regarding when in 2015 this would occur, and the June statement lacked clarity as well. In fact, the only changes to the statement stemmed from the Committee’s review of economic activity since April’s meeting, leaving the policy language unchanged.

According to the statement, FOMC members agreed that “activity has been expanding moderately after having changed little during the first quarter.” The statement acknowledged progress in labor market indicators, noting that “underutilization diminished somewhat” compared to having been “little changed” in April. Furthermore, participants agreed that there had been “moderate” improvement in household spending. On the downside, the statement cited business investment and net exports as remaining “soft”. Finally, the Committee recognized that some transitory pressures have faded and energy prices have stabilized.

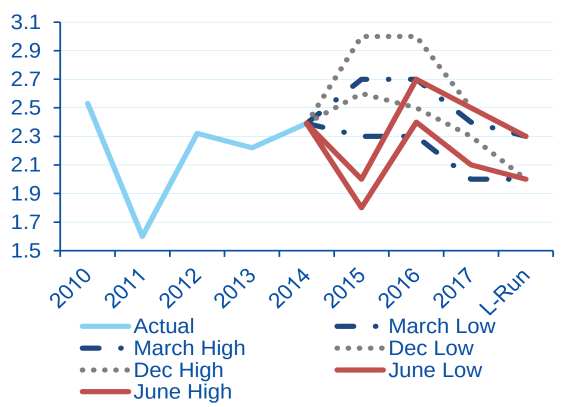
Chart 1
FOMC Voter Commentary Leading up to June Meeting



Source: Federal Reserve & BBVA Research

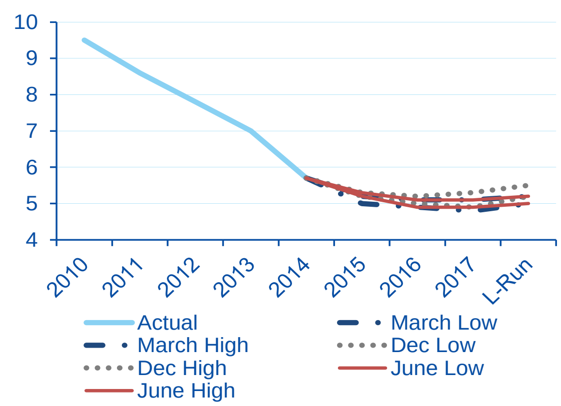
The Summary of Economic Projections for June indicates that expectations were adjusted again from the March meeting, when the FOMC significantly revised down their GDP and inflation projections. June's forecast adjustments were much less dramatic for core PCE inflation, but projections for the change in real GDP were revised down again for 2015 (from 2.3-2.7% to 1.8-2.0%). This can mostly be attributed to the slow first quarter but also reflects some lingering uncertainty regarding the slower-than-expected rebound in the second quarter. The Committee also revised their 2015 forecasts for the unemployment rate (from 5.0-5.2% to 5.2-5.3%) based on the latest assessment of current labor market slack and the understanding that cyclical weaknesses remain.

Chart 2
Change in Real GDP, 4Q % Change (Central Tendency)



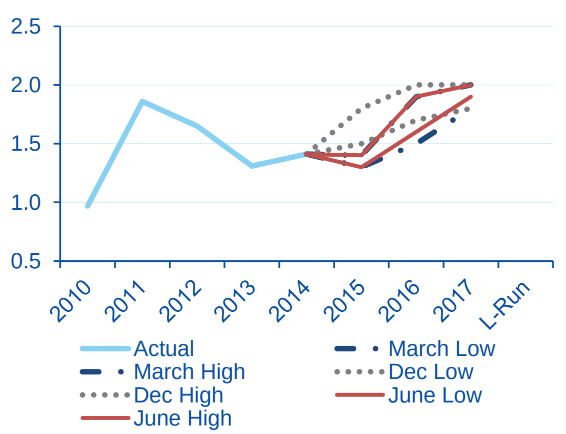
Source: Federal Reserve & BBVA Research

Chart 3
Unemployment Rate, 4Q % (Central Tendency)



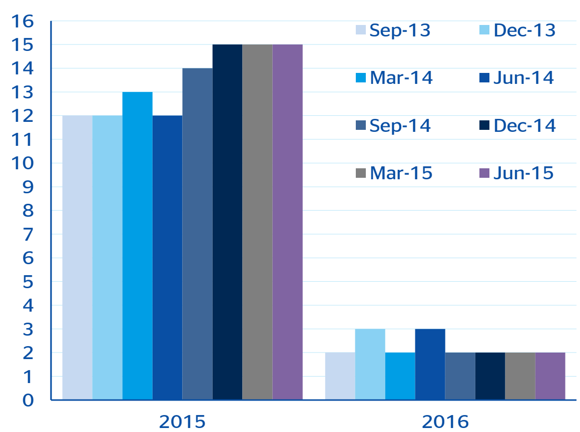
Source: Federal Reserve & BBVA Research

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



Source: Federal Reserve & BBVA Research

Chart 5
Appropriate Timing of Policy Firming (Number of Participants)

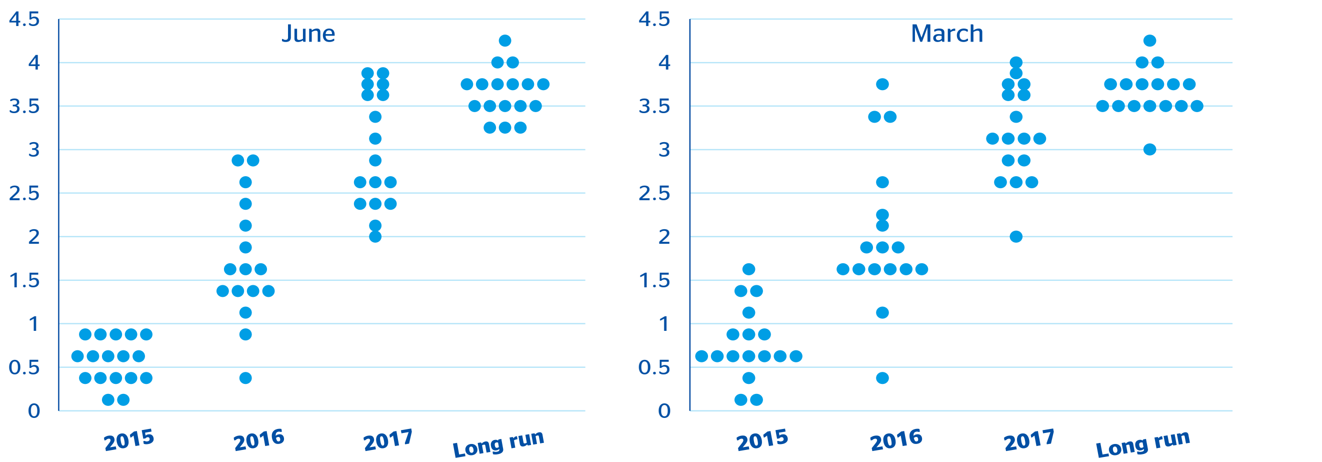


Source: Federal Reserve & BBVA Research

FOMC views on the appropriate path of tightening were significantly changed compared to March, with many members realistically adjusting 2015 expectations given that we are already half way through the year. Still, the projections suggest that all but two participants expect the first rate hike to come sometime in 2015 (Chart 5). The "dot-plot" also suggests that Committee members expect to see an average federal rates rate of 1.75% in

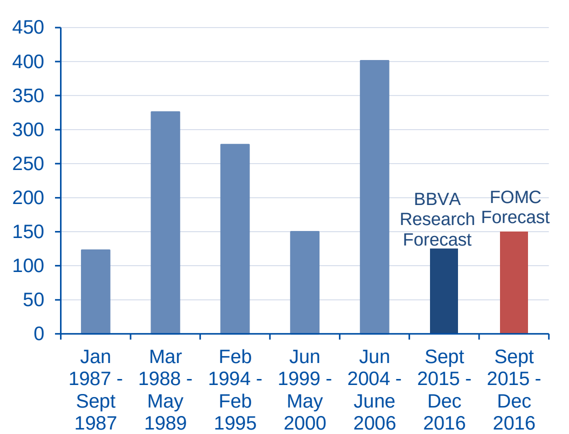
2016, 3.00% in 2017, and 3.65% in the longer-run compared to March's expectations of 2.02%, 3.18%, and 3.65%, respectively (Chart 6). This implies a 150 basis point increase during the tightening cycle through the end of 2016, slightly higher than our expectations but well below past cycles (Chart 7).

Chart 6
Target Federal Funds Rate Forecast, June vs March (Year-end %)



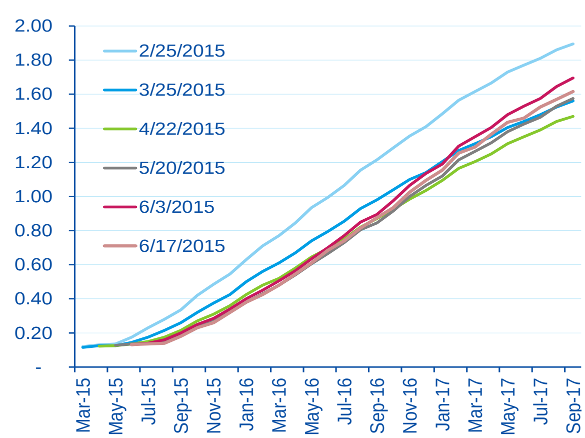
Source: Federal Reserve & BBVA Research

Chart 7
Federal Funds Rate Tightening Cycles (Basis Points)



Source: Federal Reserve & BBVA Research

Chart 8
Federal Funds Rate Futures (%)

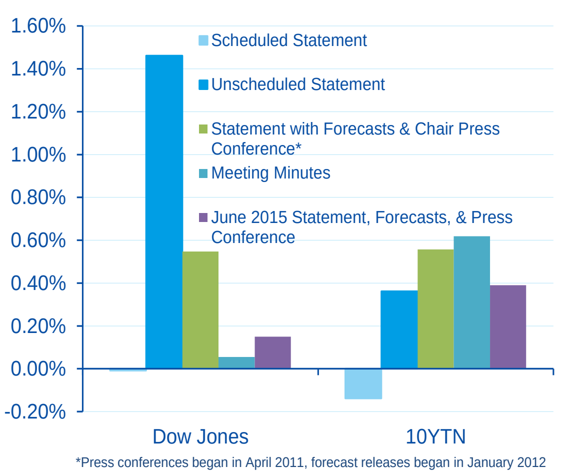


Source: Bloomberg & BBVA Research

Given that the statement didn't hold many additional clues to the Fed's timing, all eyes and ears were on Chair Janet Yellen's press conference. The biggest takeaway from her commentary was the desire to shift focus away from the first rate hike and more towards the future trajectory of the federal funds rate as this will be a better indication of how well the economy evolves over the next few years. In particular, Yellen noted that the "importance of the initial increase should not be overstated." Her emphasis on gradual and data-dependent increases suggests that rates could remain low for a prolonged period even after the initial liftoff. Yellen also reemphasized that they are still looking for further improvement in the labor market and more confident indications that inflation will move towards their target range in the mid-term. Moving forward with liftoff in 2015 would imply a pickup in growth in 2H15 as well as additional labor market improvement. Finally, she discussed the risks that the Committee continues to weigh on a meeting-by-meeting basis. Waiting too long for rate increases can cause them to overshoot their inflation objectives or could generate financial bubbles, yet raising rates too early could be detrimental to the ongoing economic recovery that still remains vulnerable.

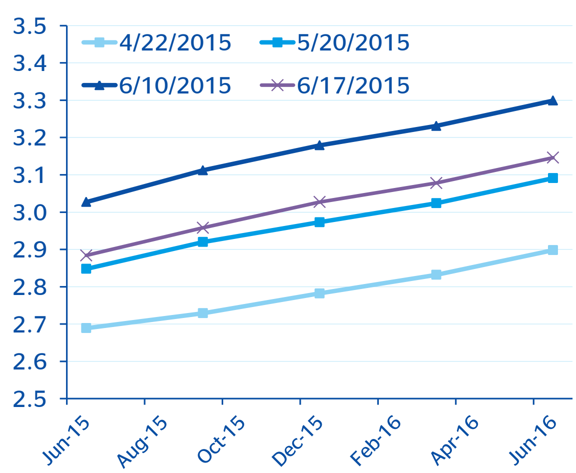
As usual, markets reacted sharply immediately following the statement release, but closed out the day showing little change from the opening bell. The 10-year Treasury Yield rose 9bp in anticipation of a possible rate hike but then dropped suddenly once the statement revealed no such action by the Fed. Equity markets jumped at the time of the release and press conference, with both the Dow Jones and S&P500 up nearly 0.9% during the afternoon. For both bonds and equities, the change was stronger relative to prior statement and press conference events.

Chart 9
Response to Fed Events, 2010-Present (Average % Change Open-Close on Day of Event)



Source: Bloomberg & BBVA Research

Chart 10
10-Year Treasury Yield Futures (%)



Source: Bloomberg & BBVA Research

Bottom Line: Rate Hike Anxiety Not Expected to Fade Away After Liftoff

Signals from the June FOMC statement, projections, and Chair press conference suggest that the first federal funds rate hike is likely to occur sometime in 2015. However, it is likely that uncertainty will linger even after the initial increase as the Committee takes each additional rate hike on a meeting-by-meeting basis. This plays hand-in-hand with our expectations, which remain unchanged for liftoff in September with a gradual pace of rate increases thereafter. However, if economic conditions deteriorate and diverge significantly from the Fed's expectations, Yellen and her FOMC colleagues could wait until December or 2016 for liftoff. Despite Yellen's prior efforts to deter markets from setting their sights only on meetings associated with press conferences, she made no mention of such theories in the latest press conference. As such, we do not expect that the FOMC will risk announcing the first rate increase at any off meeting (i.e. July or October).

DISCLAIMER