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Fed Watch

US

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Economic Analysis

US

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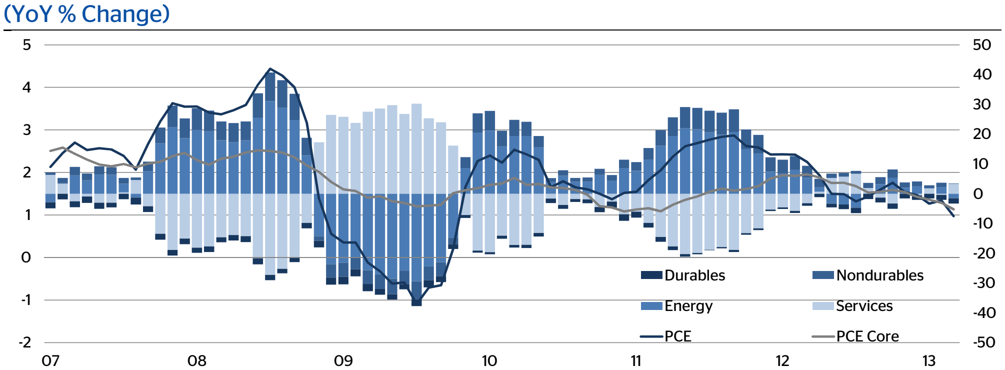
FOMC Minutes: April 30th – May 1st

FOMC Holding Strong with Current Policy Accommodation

- **We continue to expect QE3 tapering in 3Q13 despite some calls of FOMC members to decrease asset purchases as early as June**
- **Possible near future shift of purchases from MBS to Treasury securities**
- **FOMC expects inflation rate to run at or below 2% due to slack in resource utilization**
- **Subdued improvement of economic growth and labor market conditions not sufficient for sustainability**
- **Forward guidance will be the key policy tool to contain inflationary expectations when the FOMC undertakes the task of balance sheet normalization**
- **Bernanke's Congressional testimony reinforced our view on the stance of monetary policy**

The FOMC minutes from the April 30th – May 1st meeting reveal concerns as the third round of quantitative easing rolls on. Committee members discussed distress over increased investor expectations regarding the cumulative size of QE3, thus prompting the FOMC to signal their willingness to adjust the flow of purchases with the following statement: "Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes." In regards to a specific timeline for slowing the asset purchase program, a number of FOMC members agreed that recent labor market improvements were sufficient to warrant a reduction in the pace of purchases as early as June, while only one participant called for an immediate decrease in the rate of purchases. The general expectation of softer economic data related to the fiscal drag may be prompting some members to lower their threshold for what could be considered substantial labor market improvement needed to start tapering, Therefore, we remain confident with our projection for tapering the rate of asset purchases in 3Q13.

Chart 1
PCE Chain Price Index (YoY % Change)



Source: BEA & BBVA Research

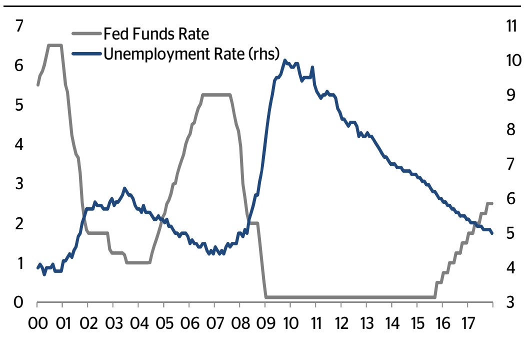
The minutes noted continued improvement in the housing sector and looked to be in agreement regarding a possible shift in the near future from MBS to Treasury securities purchases, halting the Fed's intervention further into credit allocation across sectors of economy. At the same time, FOMC participants are in agreement that QE3 continues to have a net positive effect on boosting economic activity. Accordingly, those improvements are visible in interest-sensitive sectors, as well as in loosened C&I lending terms and standards on balance. As a result, MBS bond prices declined significantly driving yields up. Today's market reaction could prove useful for Fed officials to evaluate the impact of their actions on mortgage rates.

In addition, committee members assessed the pace of economic expansion as moderate. The FOMC assessment of economic activity is based on data released in March and reflects the subdued rate of increase in private non-farm employment, slight decline in unemployment rate, minor decline in overall manufacturing production, slower growth of real business expenditures, but a solid pace of expansion in personal consumption expenditures. FOMC also acknowledged fiscal policy restraints and the weakened exports due to slower growth in Europe and China as the major headwinds to economic growth. Since the meeting, however, we have seen some shifts in the data, notably from the latest employment report. Payroll growth was revised upwards from the weaker-than-expected figures originally seen in March. On the other hand, manufacturing and production data confirmed the slower pace of activity leading into 2Q13.

Despite the fact that FOMC members are in agreement that inflation expectations remained stable and well anchored, the latest slowdown in headline and core PCE spurred a discussion among meeting participants regarding the near future monetary policy actions. The minutes revealed that a couple of members suggested that "additional monetary response might be warranted should inflation fall further." Overall, medium-term inflation is expected to run at or below 2% due to slack in resource utilization, ultimately supporting the Fed's decision to maintain its current policy accommodation as is for the time being.

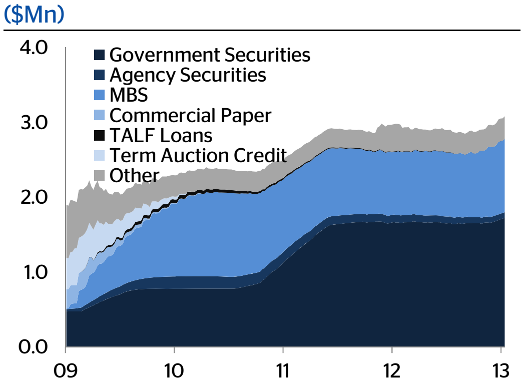
As QE3 nears its final stages, the meeting minutes are revealing more details on the FOMC's exit strategy. The details highlight the Committee's discussion on a need to further review their Exit Strategy Principles outlined back in June 2011. This is somewhat of a delayed reaction on the FOMC's behalf to the general public sentiment of questioning how well they are prepared for an appropriate exit and normalization of the balance sheet, which will be close to $4tr by year-end. The need for more transparent communication through the balance sheet normalization process and use of forward guidance as policy tool will be essential when the FOMC begins to follow through with its exit strategy.

Chart 2
Fed Funds & Unemployment Rate (%)



Source: FRB & BBVA Research

Chart 3
Federal Reserve Balance Sheet ($Mn)



Source: Federal Reserve & BBVA Research

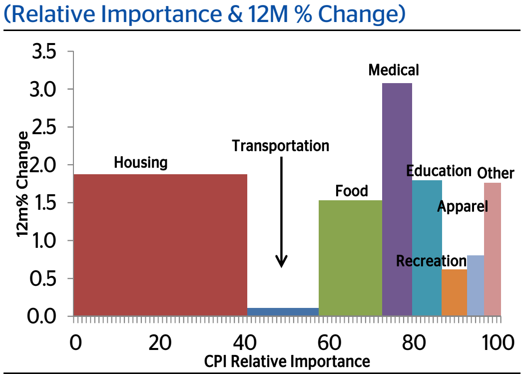
The Committee acknowledged that the broad principles outlined in the June 11 exit strategy are still valid, but they believe that there should be flexibility regarding the details of normalization policy to complement the future economic and financial conditions. The minutes state that the discussion centered on the range of reserve draining tools available and "the approach to sales of securities." What the minutes did not state is the likely agreement among FOMC members to restrain from MBS sales during the normalization process and letting them to mature instead. Both Bernanke's (Federal Reserve Chairman) testimony before the Joint Economic Committee of the U.S. Congress today and Dudley's (President, Federal Reserve Bank of New York) speech of yesterday reflected the possible consensus among the FOMC on this matter.

Bernanke's testimony ahead of the release of the minutes was more dovish. The Chairman stated that "a premature tightening of monetary policy could lead interest rates to rise temporarily," but would also impose risk to economic growth, influence a further decline in the inflation rate, pose risks to financial stability outcomes, and lead to "extended periods of lower, not higher, interest rates." In addition, Bernanke speculated that if structural unemployment is reached earlier than expected and inflation rises then the Fed will have to increase rates sooner than currently anticipated. He also supported the notion of alternating the FOMC exit strategy to allow for securities to mature. The testimony together with the minutes did not shift our view on the current stance of monetary policy.

Bottom Line: FOMC Sticking to its Guns on QE3

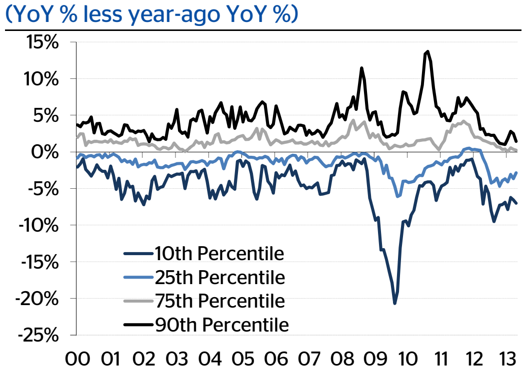
Although market anxiety on the end of QE3 continues to build up, the Fed is not ready to shift gears just yet. We are definitely seeing some underlying pressures within the FOMC to slow asset purchases in the near term, but there remains divided consensus on whether current economic conditions warrant such immediate action. With Bernanke reigning, it appears that the Fed will hold off as long as possible before making any major market-moving changes. Thus, we maintain our baseline projections for tapering of QE3 starting in 3Q13, with the program ultimately ending by 1Q14. We expect that the upcoming meetings will reveal further discussion on an appropriate exit strategy.

Chart 4
Contributions to CPI (Relative Importance & 12M % Change)



Source: BLS & BBVA Research

Chart 5
12M Relative Consumer Price Distribution (YoY % less year-ago YoY %)



Source: Federal Reserve & BBVA Research