Fed Watch

US

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Economic Analysis

US

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FOMC Statement: September 17-18th

QE3 Remains Unchanged with No "Preset Course"

- **The FOMC left the $85 billion per month asset purchase pace unchanged and "decided to await more evidence that [economic] progress will be sustained"**
- **Markets react to the unexpectedly dovish monetary policy stance**
- **Economic projections revised GDP growth down for 2013 and 2014, while 1 additional Committee member expected the federal funds rate hike in 2016**

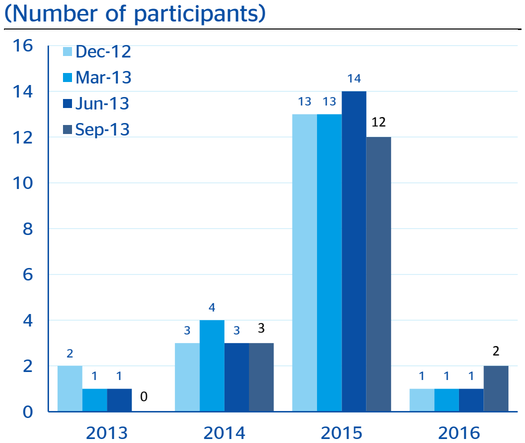
Today market participants were positioned for the FOMC to announce its scale back of the monthly large scale asset purchases (LSAP) and were expecting to face an environment of increasing interest rates as the FOMC gradually winds down QE3. But surprisingly, the FOMC took a dovish policy stance and left the balance sheet policy unchanged at a monthly purchase pace of $40 billion in mortgage-backed securities (MBS) and $45 billion in longer-term Treasury securities. The unexpected dovish stand expressed both in the FOMC statement and in Chairman Bernanke's press-conference led to a 17 basis point decrease in the 10-Year Treasury yield to 2.69% as well as a 20.76 point increase in the S&P500 to 1,725.52, a gain of 1.22%.

Voting against today's FOMC action was Esther George (Federal Reserve Bank of Kansas City), who remained concerned about the increased risks of future financial imbalances and inflation expectations. Notably, two FOMC governors, Elizabeth A. Duke and Sarah Bloom Raskin, left the Committee in September.

Why didn't the Fed taper QE3?

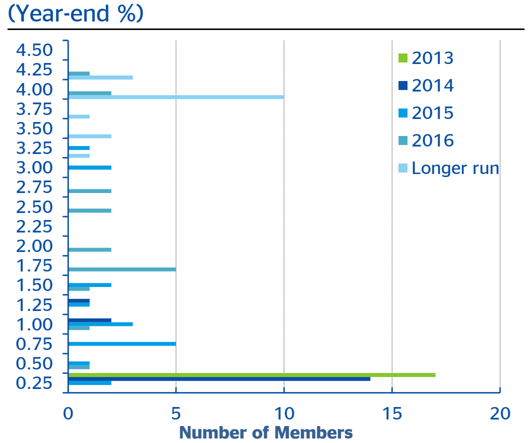
Well aware of the market expectations for today's announcement, the FOMC statement introduced several additional sentences to explain its stance regarding the further pace of LSAP and today's decision. According to the statement, "the Committee decided to await more evidence that [economic] progress will be sustained before adjusting the pace of its purchases."

Chart 1
Appropriate Timing of Policy Firming (Number of participants)



Source: Federal Reserve & BBVA Research

Chart 2
Target Federal Funds Rate Forecast (Year-end %)



Source: Federal Reserve & BBVA Research

On the front-line of FOMC worries with regard to the sustainability of economic improvement were recent "tightening of financial conditions," referring to the one month steepening of the yield curve and the increase in mortgage rates to a two-year high, as well as the fiscal policy uncertainty, as Congress deals with a potential government shutdown and rising the debt ceiling.

Another reason for postponing today's tapering announcement was the earlier experience of June 19th in which the FOMC communicated hawkish news on QE3 in conjunction with downward revisions of FOMC projections on the unemployment rate. This resulted in confusion by market participants over the possible dial-back of QE3 with a broad monetary policy tightening outlook.

The FOMC economic projections published today did have a hawkish undertone. The unemployment rate was once again revised downward, reaffirming that the Committee's projection of a 6.5% policy threshold rate would be reached in 2014. At the same time, while 14 out of 17 Committee members projected that the federal funds target rate will stay at 0.25% in 2014, the 2015 rate distribution was dispersed with a majority projecting rates between 0.75% and 1.5%. The FOMC economic projections also revised down mid-term GDP growth rates

What to Expect?

The FOMC stressed the data-driven nature of QE3 as well as the Committee's readiness to modify the pace of LSAP as economic conditions evolve. The Committee statement assertively read: "Asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's economic outlook. "Both the statement and the Chairman's press-conference highlighted that while they view labor market as being on the right course for improvement they will continue to watch for the sustainability of those improvements."

Additionally, the statement focused on the importance of upward movement in the inflation rate to meet its two percent target. The statement reaffirmed that: "in judging when to moderate the pace of asset purchases, the Committee will, at its coming meetings, assess whether incoming information continues to support the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective."

Bottom Line: QE3 taper postponement putting higher pressure on interest rates in 4Q13

Postponing a QE3 tapering announcement was welcomed by the markets. However, going forward, there is higher uncertainty for financial markets regarding the expected path of QE3 as well as the Fed's successful exit and policy normalization. The questions on when and how the QE3 should be expected to be scaled down remained unanswered. Thus, tapering can likely result in a steeper pace for the wind-down process, a decreased credibility of future QE3 policy announcements, and an increase in financial markets volatility as market expectations of tapering news will grow by December (Fed Watch September 10). The Fed's actions clearly remain data-driven and thus contingent upon labor market conditions and inflation. If conditions improve in the next two months, the FOMC could announce its plan to scale down QE3 in December. However, if the recovery stalls, the FOMC could delay tapering until 2014.

Table 1
Federal Reserve Forecast Comparison: September 18th FOMC Statement and Press Conference (Central Tendency)

	September 2013 FOMC Projections						June 2013 FOMC Projections				
	2013	2014	2015	2016	Longer run		2013	2014	2015	2016	Longer run
	GDP, 4Q yoy % change						GDP, 4Q yoy % change				
Low	2.0	2.9	3.0	2.5	2.2	Low	2.3	3.0	2.9	n.a.	2.3
High	2.3	3.1	3.5	3.3	2.5	High	2.6	3.5	3.6		2.5
	Unemployment rate, 4Q %						Unemployment rate, 4Q %				
Low	7.1	6.4	5.9	5.4	5.2	Low	7.2	6.5	5.8	n.a.	5.2
High	7.3	6.8	6.2	5.9	5.8	High	7.3	6.8	6.2		6.0
	Core PCE, 4Q yoy % change						Core PCE, 4Q yoy % change				
Low	1.2	1.5	1.7	1.9		Low	1.2	1.5	1.7	n.a.	
High	1.3	1.7	2.0	2.0		High	1.3	1.8	2.0		

Source: Federal Reserve & BBVA Research