Fed Watch

US

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Economic Analysis

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FOMC Statement: December 17-18th

Let the Tapering Begin! Pace of Asset Purchases Reduced to $75bn

- **Monthly Treasury and MBS purchases will drop by $5bn each**
- **Enhanced forward guidance; no changes to the thresholds**
- **What's next? Data dependent steps without a predetermined course**

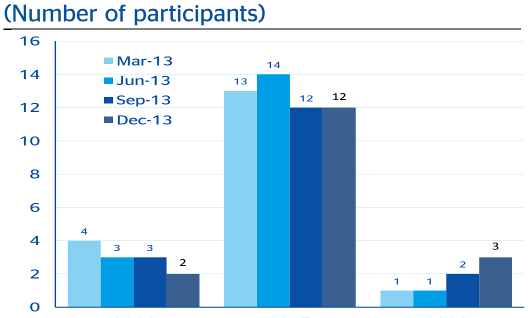
The long-awaited tapering announcement has finally arrived, setting up 2014 to be the year of the Fed. FOMC members agreed to reduce the pace of asset purchases by $10bn to $75bn per month beginning next January, in an even split between Treasuries and mortgage-backed securities (MBS). The FOMC meeting statement noted no change to the forward guidance thresholds.

Today we observed a record low swap spread, the difference between the two-year swap rate and the comparable-maturity Treasury note yield dropped to record low of 5 basis points. At the same time there was not much reaction in the Treasury market given that tapering had already been priced in. The statement today led to a 4 basis point increase in the 10-Year Treasury yield to 2.88% as well as a 1.66% increase in the S&P500.

The small change in Treasury yields reflects that markets were positioned for tapering in the near term and better communication and understanding of the Fed strategy. The surprise uptick in equities reflects the FOMC success in emphasizing the importance of balance sheet holdings –stock- relative to the monthly purchases –flows. The still cautious overtone implied by the changes to the statement related to the low inflationary environment, as well as a later timing for the first rate hike compared to September's projections. In fact, the number of committee members expecting the first rate hike in 2015 remained unchanged at 12, while three members now anticipate a rate hike in 2016; the highest number ever and for the first time, higher than the number expecting a rate hike in 2014.

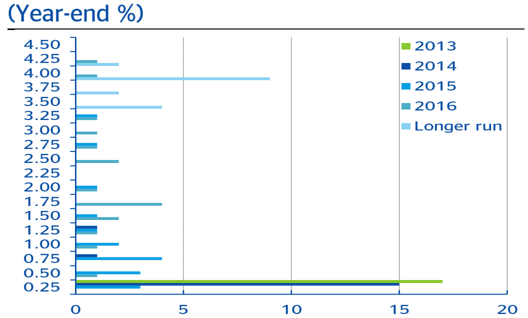
The pace of asset purchases remains data driven, and as such the FOMC committed to wind-down "in further measured steps at future meetings," contingent on incoming data. The statement alluded to the point that these measured steps for tapering are not set on a predetermined course. Labor market improvements were the main driver in the FOMC's decision to taper, outweighing concerns of low inflation. To that point, most FOMC members agree that inflation will trend towards the 2.0% target.

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

To satisfy the FOMC doves -still doubtful on tapering- and the inflation watchers, the FOMC reinforced that the Fed Funds rate will remain near zero "well past" the 6.5% unemployment rate threshold "especially if projected inflation continues to run below the Committee's 2 percent longer-run goal." There was change of suits in FOMC as the hawk George voted for, and the dove Rosengren, voted against the policy statement.

In addition, the language was revised to be more in favor of labor market improvements, with the statement acknowledging "cumulative progress toward maximum employment" and the fact that the outlook has "become more nearly balanced." Given the rising concerns regarding low inflation, the committee agreed that "it is monitoring inflation developments carefully" with the expectation that it will eventually move back towards the 2.0% target.

Along with the weighted decision to taper, the FOMC also released an updated Summary of Economic Projections. In accordance with the better-than-expected GDP and employment data in recent months, the committee revised down their unemployment rate projections.

Chairman Bernanke's final press conference revealed little about the degree of consensus behind today's decision. For the most part, Bernanke reemphasized the FOMC statement, particularly the fact that tapering will occur in measured steps while avoiding setting a target end for QE3 saying that "moderate" taper-steps would proceed "going forward throughout 2014."

Bottom Line

The Fed met our expectations for the initial timing of reduction in the pace of asset purchases, and in particular regarding the even split between Treasuries and MBS. Looking ahead, we expect the Fed to continue with cautious measured steps for reducing QE3. We expect that this gradual tapering process could take us through to 4Q14, given that the Fed will uphold the $10bn increments.

Now that the tapering process has begun, questions on monetary policy will shift toward the ability to assure a smooth normalization process, including the unwinding of the balance sheet, the effectiveness of additional policy tools such as term deposits and interest rate on excess reserves. In addition, forward guidance thresholds and the timing of the first rate hike will draw more attention.

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

	December 2013 FOMC Projections					September 2013 FOMC Projections				
	2013	2014	2015	2016	Longer run	2013	2014	2015	2016	Longer run
	GDP, 4Q yoy % change					GDP, 4Q yoy % change				
Low	2.2	2.8	3.0	2.5	2.2	2.0	2.9	3.0	2.5	2.2
High	2.3	3.2	3.4	3.2	2.4	2.3	3.1	3.5	3.3	2.5
	Unemployment rate, 4Q %					Unemployment rate, 4Q %				
Low	7.0	6.3	5.8	5.3	5.2	7.1	6.4	5.9	5.4	5.2
High	7.1	6.6	6.1	5.8	5.8	7.3	6.8	6.2	5.9	5.8
	Core PCE, 4Q yoy % change					Core PCE, 4Q yoy % change				
Low	1.1	1.4	1.6	1.8		1.2	1.5	1.7	1.9	
High	1.2	1.6	2.0	2.0		1.3	1.7	2.0	2.0	

Source: Federal Reserve & BBVA Research