Fed Watch

US

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Economic Analysis

US
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FOMC Statement: January 28 – 29th

Pace of Purchases Further Reduced to $65 Billion

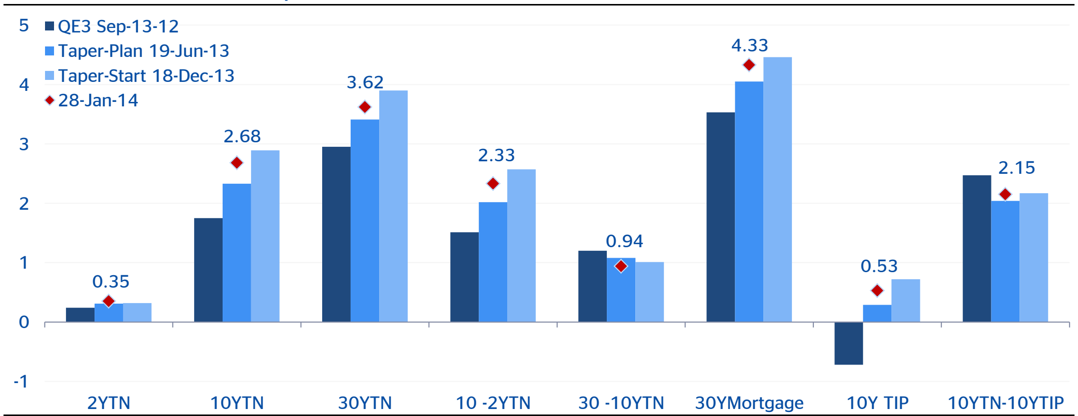
- **Monthly Treasury and MBS purchases trimmed by another $5bn each**
- **Forward guidance and thresholds kept unchanged**
- **First unanimous vote since June 2011**

FOMC statement was in line with our expectations for reducing the pace of Large-Scale Asset Purchases (LSAP) to $65bn per month (Fed Flash of January 28). Beginning in February the Committee will purchase $30bn in mortgage-back-securities (MBS) and $35bn in longer-term Treasury securities, as well as continue reinvesting principal payments into MBS and rolling over maturing Treasury securities at auction. Today's action occurred despite turmoil in emerging financial markets.

The FOMC underscored its commitment to the course of tapering by stating: "If incoming information broadly supports the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings."

U.S. Treasury yields continued declining even after the announcement. The yield on the 10-year government bond declined 8 basis points to 2.68%. This marked a 34 basis point decline since its recent peak and the lowest rate since November 18, 2013. While these movements may reflect the effects of negative economic news abroad, global financial rebalancing and flight-to-safety, they could also suggest a slight downward correction in domestic growth expectations after a highly optimistic position at the end of 2013. Moreover, these movements reflect that market participants have adjusted their fed funds rate expectations closer to those implied by the FOMC policy firming projections.

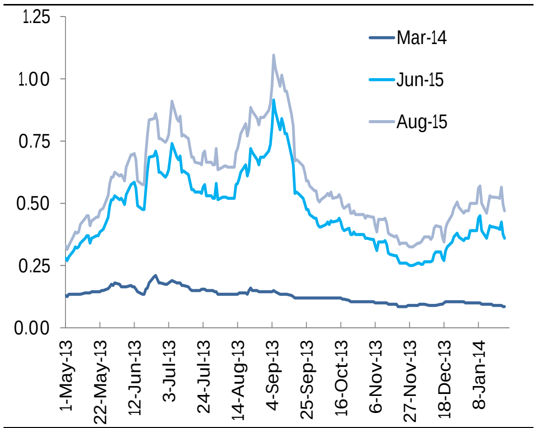
Chart 1
FOMC Announcements Impact on Interest Rates (%)



Source: Federal Reserve & BBVA Research

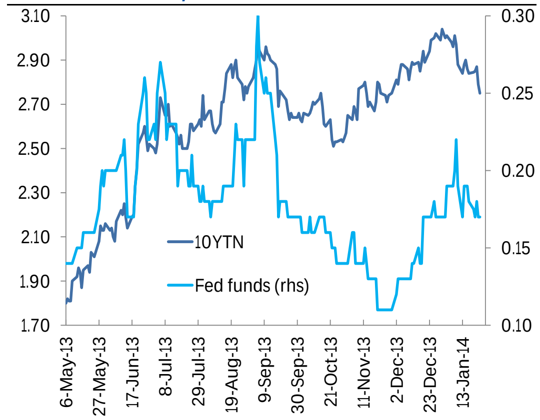
FOMC assessment of the state of the economy was overall positive signaling that "growth in economic activity picked up in recent quarters". Moreover, the statement acknowledged that "labor market indicators were mixed but on balance showed further improvement," and "economic activity will expand at a moderate pace." Officials appear at ease with inflation running below target given that "longer-term inflation expectations have remained stable."

Chart 2
Federal Funds Futures (%)



Source: CBOT & BBVA Research

Chart 3
10-Year Treasury & 12m Fed Fund Futures (%)



Source: Department of the Treasury, CBOT & BBVA Research

The last meeting led by Chairman Bernanke had an additional milestone to note - the FOMC statement was supported with a unanimous vote, which hadn't happened since the June 2011 meeting.

In addition to its regular statement, the FOMC also released two additional notes addressing the Desk's purchases of Treasuries and MBS and the Overnight Fixed-Rate Reverse Repurchase Agreement (ON RRP) operational exercise. The first note clarified that the operational aspects of LSAP purchases remain unchanged. The second note increased the cap per counterparty from $3bn to $5bn. In addition, the authorization to conduct this exercise was extended one year, through January 30, 2015.

Bottom Line: The timetable of measured steps QE3 reduction is unchanged

The Fed kept LSAP dependent on the economic outlook. In particular, improvement of labor markets conditions, and the path of inflation expectations. In addition, LSAP is conditional on the efficacy and costs of such purchases. While the Fed's balance sheet will continue to rise, the pace of monthly asset purchases will continue to decline. If current economic trends continue, we expect a 10$bn reduction at each subsequent meeting. In the absence of new economic distress and negative fiscal policy surprises the FOMC will conclude QE3 in late 2014.

Although the thresholds were left unchanged, FOMC members probably continued discussing alternatives to narrow the gap between the timing of policy firming and the unemployment rate threshold. It is likely that the majority prefers to wait for more clarity on labor market conditions while some may prefer to add other unemployment indicators to their communication policy. This will allow the Fed to keep the timing of policy firming close to 2015 even if the unemployment rate were to reach 6.5% or lower in coming months.