RESEARCH

# Fed Watch

US

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Economic Analysis

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## FOMC Statement: March 18-19th

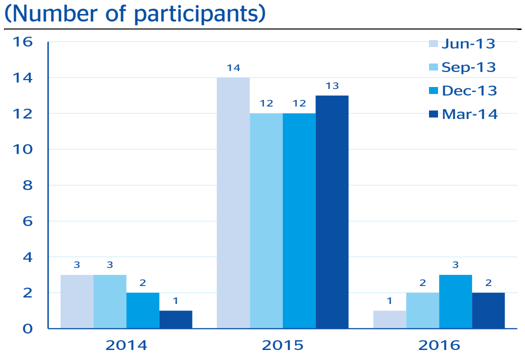
### Yellen Starts Her Chairmanship with Strong Move on Guidance

- **Unemployment rate threshold of 6.5% is scraped**
- **Pace of tapering on track with monthly Treasury and MBS purchases dropping by another $5bn each**
- **Majority continue to expect first rate hike in 2015**
- **Yellen's press conference hints that timing of first rate hike might be sooner than market expectations**
- **FOMC economic projections were more hawkish than the statement, adding noise to Fed's communication policy**

As we expected, faced with faster than expected decline in the unemployment rate, FOMC statement acknowledged that the 6.5% unemployment rate threshold became outdated. In turn, FOMC members agreed to "update" forward guidance thresholds with a reference to progress "toward its objectives of maximum employment and 2 percent inflation", thus removing the numeric threshold for unemployment. To avoid confusion in market expectations, the Committee concluded today's statement with an additional paragraph restating that eliminating the 6.5% unemployment rate threshold from its guidance "does not indicate any change in the Committee's policy intentions as set forth in its recent statements."

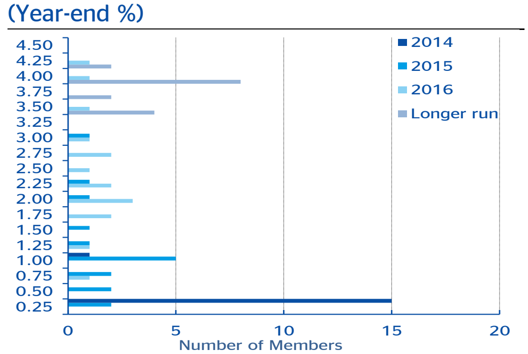
Meanwhile, the paragraph on forward guidance thresholds was replaced with qualitative description that "the Committee will assess progress--both realized and expected--toward its objectives of maximum employment and 2 percent inflation," and that "this assessment will take into account a wide range of information" pertaining labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. In addition, the FOMC made it clear that rates would remain low for some time even as the output gap narrows and inflation returns to target. In part, this reflects the Fed's strategies to anchor fed funds rate expectations and assure an orderly yield curve normalization process.

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

Despite the overall dovish undertone during Chair Yellen's press-conference, her remarks in the Q&A session that QE3 could end in the fall and that "considerable time" means six months was surprisingly hawkish, as it implies that policy tightening could happen as early as 1H15. However, drawing conclusion is premature, given that the rate hike is still conditional on upbeat economic data and no risk of disinflation. Moreover, she could have meant "at least six months" thus setting the first rate hike in 2Q15; only slightly earlier than market expectations. Fed communication in the next few days will be useful to assess what Yellen really meant regarding the six months period.

In line with our expectations, the Committee announced that next month's pace of asset purchases will decline to $55bn, spread to $25bn mortgage backed securities and $30bn of Treasuries. While the pace of tapering remains data driven, the soft economic data in 1Q14 were not considered a hurdle, and were viewed by FOMC as "in part reflecting adverse weather conditions." Going forward, tapering seems to be on auto pilot. The FOMC will likely continue to gradually wind-down Large Scale Asset Purchases (LSAP) by $10bn at each meeting.

Kocherlakota (President, FRB Minneapolis), who previously advocated for stronger guidance and replacing the 6.5% unemployment threshold with a numeric target of 6.0%, voted against today's FOMC actions. His dissent had dovish undertones, stating that the paragraph on forward guidance "weakens the credibility of the Committee's commitment to return inflation to the 2 percent target from below and fosters policy uncertainty that hinders economic activity."

Market participants perceived the statement implied an earlier rate hike, causing a 4bp increase in 10-Year Treasury yield to 2.75%. The trend continued during FRB Chair Yellen's press conference as 10-Year Treasury yield increased to 2.77% and S&P500 closed at 1,860.77, a 0.61% decline. The upward movement in yields in response to the statement is somewhat beneficial for the Fed as it reduces risk-taking.

There were only minor changes to the summary of Economic Projection. Changes mostly reflected the most recent releases on employment, as both lower and upper bounds for the unemployment rate were revised down. At the same time, the upper bound for expected GDP growth was revised slightly downward.

## Bottom Line

As the tapering path is set, the FOMC focus is shifting towards crafting an effective communication strategy for policy tightening. Yellen started her chairmanship with a strong move to redefine forward guidance and anchor expectations for the exit strategy. At the same time, the message communicated by Yellen was a mixed and the soon to be released minutes will likely add clarity. Assuming that the Fed maintains the $10bn per month incremental reductions, asset purchases will likely continue until 4Q14. For now, our expectation for the first federal funds rate hike remains in 3Q15. To avoid an unwanted steepening in the yield curve, as the FOMC begins to increase the federal funds rate, the trajectory of federal funds rate will remain below the levels that the Committee would view as normal in the long-run.

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

| | March 2014 FOMC Projections | | | | December 2013 FOMC Projections | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2016 | Longer run | | 2014 | 2015 | 2016 | Longer run |
| | GDP, 4Q yoy % change | | | | | GDP, 4Q yoy % change | | | |
| Low | 2.8 | 3.0 | 2.5 | 2.2 | Low | 2.8 | 3.0 | 2.5 | 2.2 |
| High | 3.0 | 3.2 | 3.0 | 2.3 | High | 3.2 | 3.4 | 3.2 | 2.4 |
| | Unemployment rate, 4Q % | | | | | Unemployment rate, 4Q % | | | |
| Low | 6.1 | 5.6 | 5.2 | 5.2 | Low | 6.3 | 5.8 | 5.3 | 5.2 |
| High | 6.3 | 5.9 | 5.6 | 5.6 | High | 6.6 | 6.1 | 5.8 | 5.8 |
| | Core PCE, 4Q yoy % change | | | | | Core PCE, 4Q yoy % change | | | |
| Low | 1.4 | 1.7 | 1.8 | | Low | 1.4 | 1.6 | 1.8 | |
| High | 1.6 | 2.0 | 2.0 | | High | 1.6 | 2.0 | 2.0 | |

Source: Federal Reserve & BBVA Research