Economic Research Department

BBVA 150 years

US

Fedwatch

January 25, 2007

Federal Open Market Committee, January 29-30

Luis Arregoces
luis.arregoces@bbvausa.com

Fed Funds: 3.50%
Next FOMC Meeting: January 29-30, 2008
Minutes Release: February 20, 2008

- **The Fed is willing to act decisively to maintain orderly functioning in financial markets, and thus lower the risk of a sharper slowdown in economic activity**
- **As a consequence of this strategy, FOMC will continue lowering the fed fund rates in the coming months**

The FOMC lowered the fed funds rate by 75 bp last Tuesday, in a "decisive" action that could have been in the cards during the meeting ending on January 30, as the economic outlook deteriorated in previous months and "appreciable downside risks to growth" remain. The rate action implemented on Tuesday was probably intended to prevent a major stock market adjustment, which could have deteriorated even more the current outlook. A contraction in equity markets would have had an impact on consumer confidence and, if entrenched, an impact on consumer wealth.

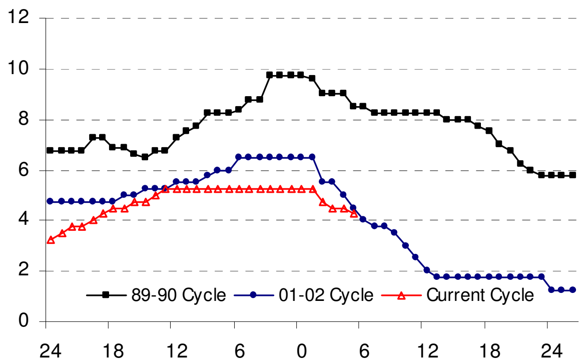
President Poole voted against the rate cut because he "did not believe that current conditions justified policy action before the regularly scheduled meeting." Many market participants interpreted Mr. Poole's remarks as an indication that the Fed's move had the specific purpose of "timely" reestablishing confidence in financial markets.

At the same time FOMC members seemed confident that core inflation is contained and inflationary expectations are well anchored. Currently, the balance of risks tilts towards lower growth rather than inflation, at least as long as long-term inflation expectations remain contained.

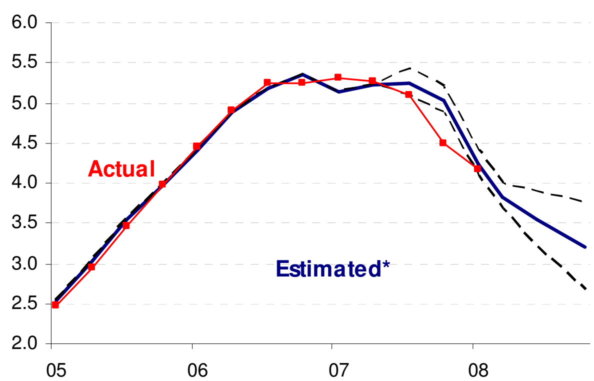
The FOMC statement has made it abundantly clear that more cuts are down the road. The likelihood of additional restrictions in credit to consumers and firms, for which there is some evidence, together with the disturbances in financial markets, which are not likely to ease in the near future, are an indication of future cuts in the fed fund rates.

Will the FOMC cut rates next week? It is hard to tell. On the one hand, the committee has done quite a few cuts, and at some point, members have to stop giving the impression that any additional piece of negative evidence is a surprise for them that merits further cuts. Nothing remarkable has taken place since Tuesday that could change the view that led them to cut rates. On the other hand, the market will have a hard time understanding the past statement, which stresses the need for timely action, as an indication of more rate cuts. As of today, the market discounts a 50 bp in the next FOMC meeting. If the FOMC decides to hold rates in this environment, it risks generating a stock and money market turbulence; likely, this is what the committee wanted to avoid by cutting rates last Tuesday (had it wanted to avoid these expectations it could have probably used other language in the statement). Next week is very important for market participants, in order to see what the FOMC wants and/or fears.

Fed funds rate: easing cycles
(eop, monthly rates)



Fed Funds: Actual BBVA USA
Taylor Rule (Quarterly average, %)



*Output gap, inflation and inflation expectations were used as dependent variables. The upper (lower) range considers a wider (narrower) output gap, higher (lower) inflation and inflation expectations

Table1: Economic Indicators

	Q406	Q107	Q207	Q307	Q407**	Effect*	Value*
Capacity utilization (%, quarterly average)	81.5	81.4	81.6	82.2	81.5	◄►	0
Industrial production (Q/Q annualized change)	-1.5	1.1	3.4	4.3	-0.9	▼	-1
Capital goods new orders*** (Q/Q change)	-1.5	-4.3	3.1	0.8	-2.1	▼	-1
ISM (index, average)	50.9	50.8	55.2	52.9	49.8	▼	-1
Output per hour (Q/Q annualized change)	1.8	0.7	2.6	6.3	-	◄►	0
Unit labor costs (Q/Q annualized change)	10.4	5.1	-0.9	-2.2	-	◄►	0
Employment cost index (Q/Q annualized change)	3.2	2.3	3.5	4.7	-	◄►	0
Average Hourly Earnings (Q/Q annualized change)	3.9	3.7	3.9	4.1	3.3	◄►	0
Real disposable income (Q/Q annualized change)	6.2	5.4	-0.8	4.4	0.0	◄►	0
Real personal spending (Q/Q annualized change)	3.9	3.7	1.4	2.6	2.6	◄►	0
Consumer confidence (index, average)	106.8	109.9	106.7	105.7	90.5	▼	-1
Unemployment rate (% quarterly average)	4.5	4.5	4.5	4.6	4.8	▼	-1
Nonfarm payroll (Q/Q annualized change)	1.5	1.5	1.2	0.9	0.9	▼	-1
PCE (eop, 12-month change, sa)	2.3	2.5	2.3	2.4	3.0	▲	1
Core PCE (eop, 12-month change, sa)	2.3	2.3	1.9	1.9	2.0	◄►	0
CPI (eop, 12-month change)	2.5	2.8	2.7	2.8	3.5	▲	1
Core CPI (eop, 12-month change)	2.6	2.4	2.2	2.1	2.2	◄►	0
PPI ex food & energy (eop, 12-month change)	2.0	1.5	1.8	2.0	2.5	▲	1
Implicit inflation 10-year Note (eop, annual, %)	2.2	2.4	2.4	2.2	2.3	◄►	0
12m Inflation expectations (U. Michigan, avg. %)	3.0	3.0	3.3	3.3	3.1	◄►	0
Sum*	6	6	4	2	-3		

* BBVA USA interpretation for the restrictive stance of monetary policy: ▲ more, ▼ less, ◄► neutral; a 1 is assigned to ▲, 0 to ◄► y -1 to ▼, thus, a greater (lower) sum implies a greater (lower) probability of a hike.
PCE = personal consumption expenditures deflator; CPI = consumer price index
** Only considers the months of the quarter with available information; *** Excluding defense & aircraft

Fed Funds Rates Implied Probability

FOMC-January 08	25-Jan-08	18-Jan-08	21-Dec-07
Decrease to 3.00	31.6%	0.0%	0.0%
Decrease to 3.25	30.0%	3.2%	0.0%
Decrease to 2.75	27.6%	0.0%	0.0%
No change	10.8%	37.5%	0.0%
FOMC-March 08			
Decrease to 2.75	47.1%	6.0%	0.0%
Decrease to 3.00	16.3%	16.0%	0.2%
Decrease to 3.25	13.6%	35.3%	1.1%
Decrease to 2.25	13.2%	0.0%	0.0%

* Bloomberg Survey

Fed Funds Expectations
(BBVA USA & Fed Funds futures, end of contract, %)

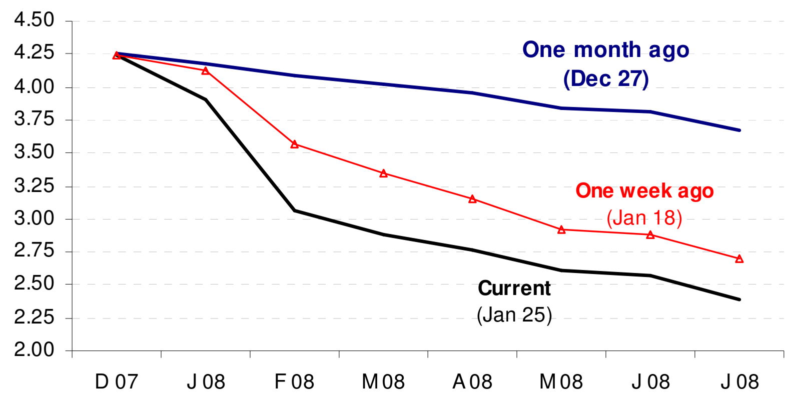
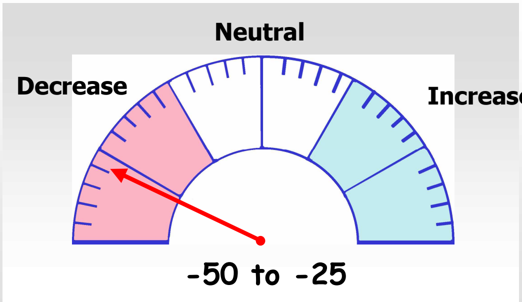


Table 2: Fed officials' speeches

	Ben Bernanke Chairman	Frederic Mishkin Governor	Dennis Lockhart President Atlanta Fed	Donald Khon Vice Chairman	Interpretation
Activity	..perhaps an even greater challenge was posed by a sharp and protracted correction in the U.S. housing market, which followed a multiyear boom in housing construction and house prices.	The disruption in financial markets poses a substantial downside risk to the outlook for economic growth, and adverse economic or financial news has the potential to cause further strains..	Evidence of slowing economic activity has been mounting. Beyond last year's sharp drop in residential investment, growth in manufacturing output remained well below its rate of the previous year.		Downside risks to economic growth have intensified in the last weeks. The disruptions in credit markets have the potential to affect the broader economy
Productivity					
Employment	A second consequential risk to the growth outlook concerns the performance of the labor market. Last week's report on labor-market conditions in December was disappointing, as it showed an increase of 0.3 percentage point in the unemployment rate and a decline in private payroll employment.		over the past 20 or so months, year-over-year employment growth has slowed considerably.		
Capacity Utilization					
Inflation	Continued increases in the prices of energy and other commodities, together with high levels of resource utilization, kept the Committee on inflation alert.	Policymakers also need to monitor information about underlying inflation and longer-run inflation expectations, and if the evidence indicates that these inflation expectations have begun rising significantly…	increasing pressure to pass through higher prices for goods and services. For 2007, the consumer price index increased 4.1 percent—the largest calendar-year increase since 1990. The core CPI increased 2.4 percent, which is above my comfort zone.		Core inflation appears to be contained and given a flattening of energy prices in coming quarters headline inflation should converge to the levels of core inflation in 2008
Inflation Expectations	Thus far, inflation expectations appear to have remained reasonably well anchored, and pressures on resource utilization have diminished a bit.				
Monetary Policy	The Federal Reserve accordingly has taken a number of steps to help markets return to more orderly functioning and to foster its macroeconomic objectives of maximum sustainable employment and price stability.	..monetary policy needs to be timely, decisive, and flexible. ..timely action is crucial when an episode of financial instability becomes sufficiently severe to threaten the core macroeconomic objectives of the central bank.	Clearly, painful adjustments are under way in housing markets, mortgage markets, and money markets…In the weeks and months ahead, I will be watching the process of these necessary adjustments closely as I work with my colleagues to determine the appropriate monetary policy actions.	…..The enhanced projections give more information about the FOMC's medium-term outlook for the economy. That's particularly important, because the lags in the effect of policy on economic activity and prices mean that policy decisions are necessarily based on a view of the likely path for the economy over several years…	Uncertainty about the economic outlook increased significantly since the last meeting. The Fed stance on monetary policy could be less restrictive

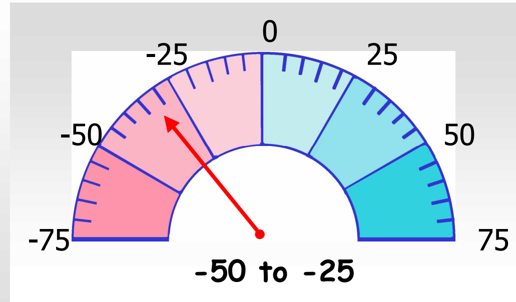
FOMC Meeting Fedometer

Economic Indicators



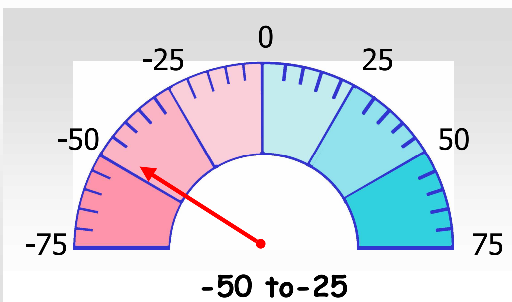
BBVA USA estimates from the analysis of economic indicators

Minutes & Fed Speeches



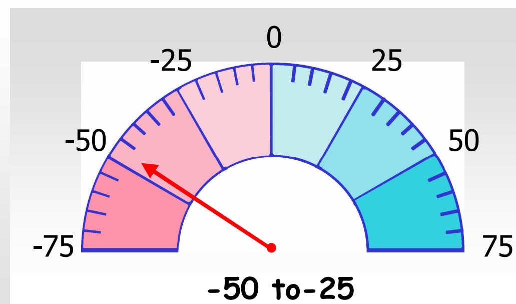
BBVA USA interpretation from analysis of FOMC minutes and Fed officials' speeches

Fed Funds Futures



Implied change:
Next month's contract

Analysts



Estimated change from
the lastest bloomberg survey

* The Fedometer shows likely changes in the Fed funds rate based on analysis of the four following sources: Economic Indicators, Minutes and Fed Speeches, Fed Funds Futures and a selected group of analysts. The number below the meter reflects the numerical change associated with each source.