Economic Research Department

BBVA

Fed Watch

September 23, 2009

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Fed Funds: 0.0-0.25%
Minutes Release: October 14, 2009
Next Meeting: November 3-4, 2009

Fed expects economic growth, but risks remain

- **Fed funds rate will remain low for a prolonged period**
- **Economic slack will keep inflation subdued**
- **Asset purchase program will be completed in 1Q10**

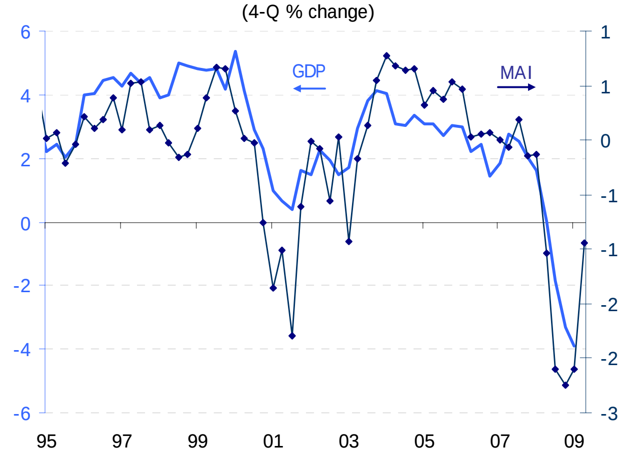
The FOMC's economic outlook has improved since the previous meeting. The committee stated that "economic activity has picked up," while the previous statement described it as "leveling out." Furthermore, the target of monetary policy measures has shifted from helping to resume economic growth to strengthening it. While the message cited further improvements in financial markets, it also highlighted increased activity in the housing sector and better alignment of business inventories with sales. Nevertheless, the statement noted that business investment and staffing are still declining, albeit at a slower pace, and ongoing job losses, sluggish income growth, lower housing wealth and tight credit markets will continue to constrain consumer spending.

The committee maintained its expectation that inflation will "remain subdued for some time." Even though economic activity is improving, substantial resource slack remains, which could counteract upward prices pressures, and long-term expectations remain stable. Accordingly, the FOMC held the target interest rate at 0%-0.25% and expects conditions to warrant keeping it at a low level for a prolonged period.

In terms of monetary policy, the committee is starting to focus on exit strategies. In addition to the previous meeting's announcement that Treasury purchases will be completed by the end of October, the Fed declared that it will gradually slow the pace of MBS and agency debt purchases and conclude the program by the end of 1Q10. Furthermore, the FOMC implied that it has the sufficient means to support its policy goals by stating that it will employ "a wide range of tools," rather than "all available tools," as declared in the previous statement.

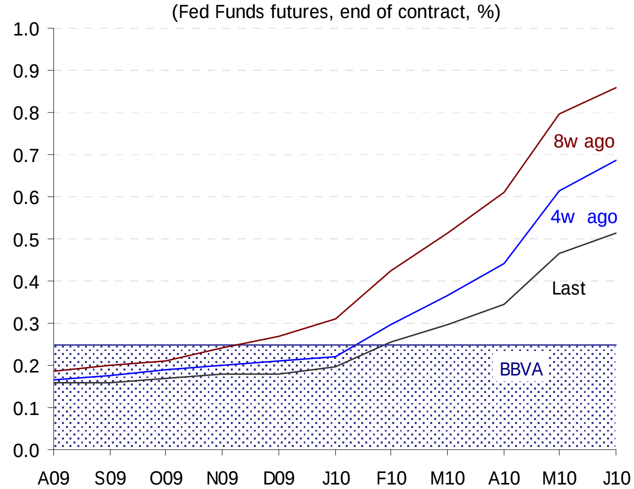
Bottom-line: By changing its outlook, the FOMC is sending a more positive message that the economy is beginning to grow, which is in line with our assessment of recent economic data. Accordingly, it is beginning to discuss the means and timing to exit its supportive policies. Although the statement had positive notes, the Fed acknowledges that risk factors and slack remain in the economy, both of which justify the decision to maintain the target rate at 0%-0.25%. Given the committee's outlook and our expectation that economic slack will endure for some time, we maintain our forecast of a low Fed funds rate for a prolonged period.

BBVA US Monthly Activity Index & Real Gross Domestic Product
(4-Q % change)



Source: BBVA ERD & BEA

Fed Funds Expectations
(Fed Funds futures, end of contract, %)



Source: Bloomberg