U.S.

Fed Watch

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Economic Analysis

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FOMC Minutes: January 25-6

Members slightly upgrade their economic outlook

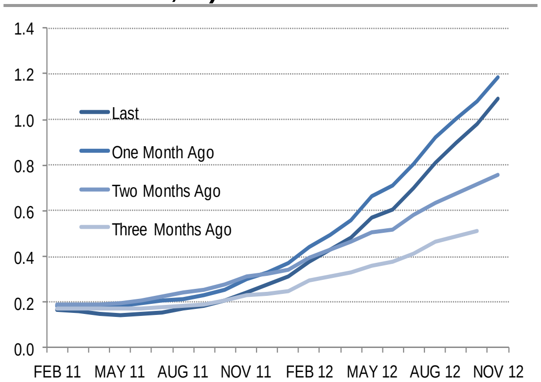
- **Fed will likely end QE2 as scheduled; data do not warrant additional purchases**
- **Consumer spending offers upside risk to FOMC economic projections**
- **Housing activity, state and local finances, and European debt present downside risks**

Meeting participants' views of inflation are largely unchanged

Today's release of the minutes from the January 25-6 Federal Open Market Committee (FOMC) reveals cautious optimism about the economic recovery and the Fed's updated forecasts (Table 1). FOMC members discussed the ongoing large-scale asset purchase (LSAP) program and structural unemployment (discussed in Chart 3). Recent speeches by Federal Reserve officials are consistent with the minutes' assertion that the LSAP program is working as planned. With regard to economic conditions, the minutes noted an uptick in consumer spending and continued outlays for equipment and software. The pace of the economic recovery, however, remains insufficient to reduce unemployment to levels consistent with the Fed's dual mandate. Moreover, some participants mentioned that incoming data on production, spending and employment needed to be solid for an appreciable time period to trigger an upward forecast revision. However, the economic projections of the members are currently very optimistic, in our estimation. Turning to inflation estimates, participants believe that declines in labor costs are counterbalanced by increases in energy and commodity prices. The Fed's business contacts report their continued difficulty in passing along price increases to consumers within an environment of high resource slack. Overall, participants viewed European fiscal pressures, the housing market, and US state and local government finance as the major downside risk factors. The possibility of increased consumer spending represented participants' upside risk factor. Some participants consider increases in energy and commodity prices as a risk factor for the inflation outlook. The issue of price pass-through of imported goods was raised during the meeting, but certain members argued that the pass-through to US consumer prices is historically minimal. Financial stability indicators like volatility and corporate spreads improved during the intermeeting period. However, the staff review noted "an atypically high level of default risk" priced into the municipal bond market.

Chart 1

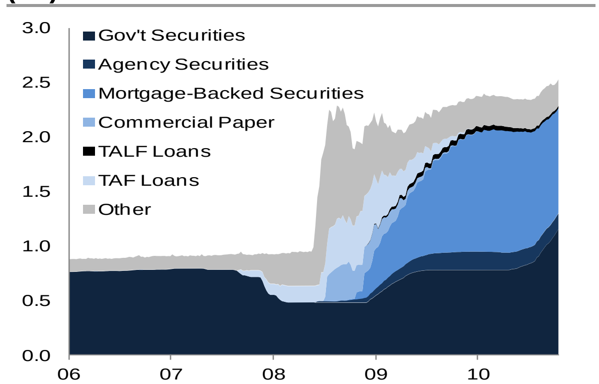
Fed Funds Expectations (Futures Contract End, %)



Source: BBVA Research and Bloomberg

Chart 2

Factors Supplying Reserve Funds ($tr)



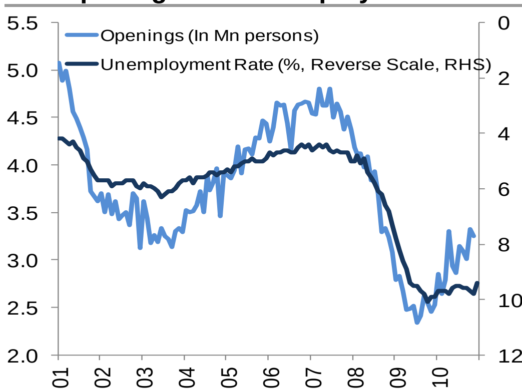
Source: BBVA Research and Federal Reserve

Our baseline scenario is for a first rate hike in 2Q12

The main theme of the minutes revolved around cautious optimism. We expect LSAP to continue to the end of 2011Q2 and that there will be no additional round of purchases. Some FOMC members doubted that the outlook could change enough to warrant adjustments to the program before its scheduled completion. The minutes are consistent with a low Federal Funds rate for an extended period of time. We continue to expect that starting in April the Federal Reserve will begin to prepare the financial markets for the end of LSAP by extolling the successes of the program. Due to a stronger-than-expected 2010Q4 and our revised 2011 GDP forecast, we expect rate increases to occur sooner than previously forecasted.

Chart 3

Job Openings and Unemployment

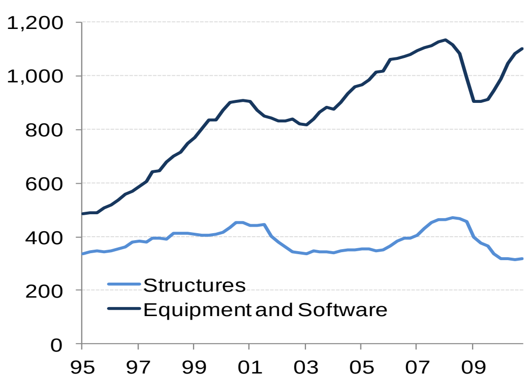


Source: BLS and BBVA Research

Similar to the previous minutes, FOMC members continue to watch for structural unemployment issues. Their discussion implies that they believe most of today's high unemployment is the result of cyclical factors and that monetary policy still can play a significant role in reducing the unemployment rate. FOMC members also pointed to the difficulty of measuring structural unemployment in real time.

Chart 4

Nonresidential Investment, in 2005 $bn



Source: BBVA Research and BEA

Personal consumption expenditures (PCE), inventories and nonresidential investment represented the main drivers of the economic recovery in 2010. Investment in nonresidential structures is lackluster, while business spending on equipment and software recovered quickly and has reached pre-crisis levels.

Table 1

Federal Reserve Forecast Comparison, January 25-6 FOMC Minutes

	November 2010 FOMC Projections				January 2011 FOMC Projections			
	2011	2012	2013	Long-term	2011	2012	2013	Long-term
GDP, yoy % change								
High	4.0	4.7	5.0	3.0	4.2	4.7	5.0	3.0
Low	2.5	2.6	3.0	2.4	3.2	2.6	3.0	2.4
Unemployment rate, %								
High	9.3	8.7	7.9	6.3	9.0	8.4	7.9	6.2
Low	8.2	7.0	5.9	5.0	8.4	7.2	6.0	5.0
Core PCE, yoy % change								
High	2.0	2.0	2.0	---	1.8	2.0	2.0	---
Low	0.7	0.6	0.5	---	0.7	0.6	0.6	---

Source: Federal Reserve

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