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Fed Watch

US

25 January 2012
Economic Analysis

US

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FOMC Statement: January 24-25
Highly Accommodative Stance

- **Statement, projections suggest first rate hike in early 2014Q4**
- **Balance sheet to remain constant until 2015 unless risk scenarios emerge**
- **Higher probablilty of asset purchases that will likely focus on mortgages**

FOMC unveils statement of long-term policy goals, new forecasts for target rate

The Federal Reserve's statement and press conference today revealed that the Federal Open Market Committee (FOMC) believes that the target Fed Funds rate will remain at or below 1% until the end of 2014. As implied by futures prices, the market had expected a first rate increase around 2014Q1, so today's statement shifted expectations for interest rates considerably farther into the future. The FOMC statement also expressed the committee's desire to remain "highly accommodative" in the light of a recovery they do not believe is self-sustaning. In particular, Chairman Bernanke's comments suggested he views recent data as unveiling only a mixed outlook for US growth. In the released projections, the Federal Reserve lowered growth projections for 2012 and 2013. The US economy, according to the FOMC and Bernanke, also faces a number of downside risks. These downside risks stem from a disorderly European sovereign debt crisis, a hard landing in emerging markets, continued trouble in domestic housing markets and persistent negative influences on consumer behavior from deleveraging. The FOMC attempted to release qualitative expectations of the size of the balance sheet with the statement and new forecast projections, but this was delayed until the minutes release since members wanted to further discuss the exact wording. However, during the press conference Bernanke offered his view of the likely size of the balance sheet going forward by discussing the timing of asset sales. Given analysis occurring several months ago, Bernanke said that asset sales would not begin until 2015.

Table 1
Federal Reserve Forecast Comparison, January 25 FOMC Statement and Press Conference

	Nov 2011 FOMC Projections				Jan 2012 FOMC Projections			
	2012	2013	2014	Long-term	2012	2013	2014	Long-term
GDP, 4Q yoy % change								
High	3.5	4.0	4.5	3.0	3.0	3.8	4.3	3.0
Low	2.3	2.7	2.7	2.2	2.1	2.4	2.8	2.2
Unemployment rate, 4Q %								
High	8.9	8.4	8.0	6.0	8.6	8.2	7.7	6.0
Low	8.1	7.5	6.5	5.0	7.8	7.0	6.3	5.0
Core PCE, 4Q yoy % change								
High	2.1	2.1	2.2	---	2.0	2.0	2.0	---
Low	1.3	1.4	1.4	---	1.3	1.4	1.4	---

Source: Federal Reserve

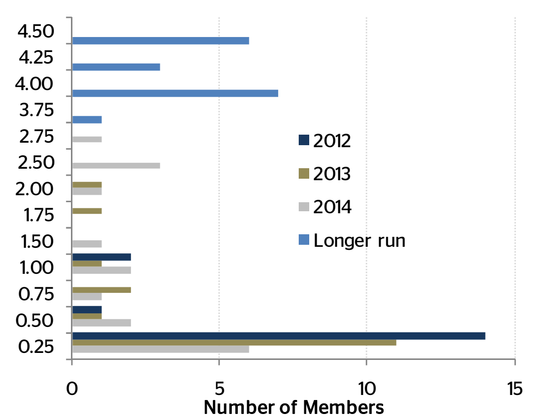
The FOMC today also clearly outlined their long-term goals for policy. In particular, the FOMC views a 2% YoY growth rate of PCE inflation as most consistent with their inflation mandate. While both inflation and maximum unemployment are equally-weighted, the FOMC will always apply flexibility to the concept based on whatever initial conditions policy faces at the time. The announcement of long-term goals for monetary policy also imply that the FOMC will not tie their efforts to a specifc unemployment rate. Unemployment in the short-term may be determined by factors other than monetary policy. As such, the FOMC will focus on the natural rate of unemployment as a loose benchmark for employment maximization. Deviation from one target or the other is tolerable and the response of monetary policy to a deviation will depend on the speed of convergence of the particular goal. Today's developments enter the FOMC into a new era of flexible inflation targeting.

The Federal Reserve remains very concerned with the US real estate sector. Bernanke regards the housing sector as partially responsible for the damaged link between monetary policy and economic activity. Over the past few weeks the Federal Reserve has recommended new refinancing initiatives to the government. Any future scheme of large-scale asset purchases is likely to involve mortgage-backed securities. Given the fixation of the Federal Reserve on housing, today's release of projections for the short-term interest rate far into the future help put downward pressure on long-term mortgage rates. The projections also lower interest rate risk for long-term lenders to the real estate sector.

Bottom line: First rate hike in 2014Q4, higher probability of asset purchases

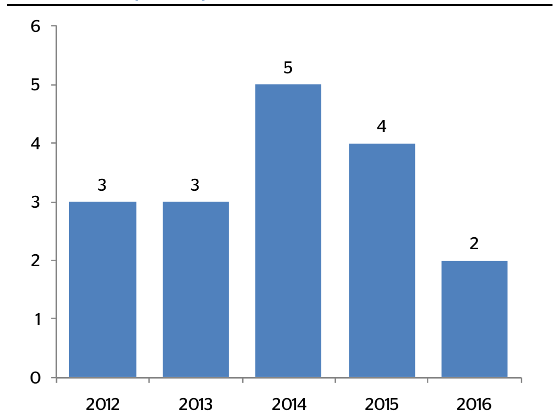
We believe that the probability of another round of large-scale asset purchases has increased, but the FOMC is not yet ready to embark on these purchases until either a tail risk event emerges (Europe sovereign debt or otherwise) or the data clearly suggests a slowdown in US growth. Possible triggers for quantitative easing, according to Bernanke, include renewed risk of deflation or poor employment generation. We also believe that the statement, projections and press conference comments imply that th Fed will be on hold until the beginning of 2014Q4. Today's developments also suggest the Fed will keep constant the size of the balance sheet until 2015, unless they engage in more asset purchases. We still regard the FOMC's projections of US GDP growth as too high, especially given the fiscal drag from expected future austerity measures.

Chart 1
Target Federal Funds Rate Forecast (Year-end, %)



Source: BBVA Research & Federal Reserve

Chart 2
Appropriate Timing of Policy Firming (Number of participants)



Source: BBVA Research & Federal Reserve