RESEARCH

# Fed Watch

US

23 February 2012
Economic Analysis

US

Boyd Nash-Stacey
boyd.nashstacey@bbvacompass.com

Jeffrey Owen Herzog
jeff.herzog@bbvacompass.com

## QE Dashboard

### Indicators support a wait-and-see approach

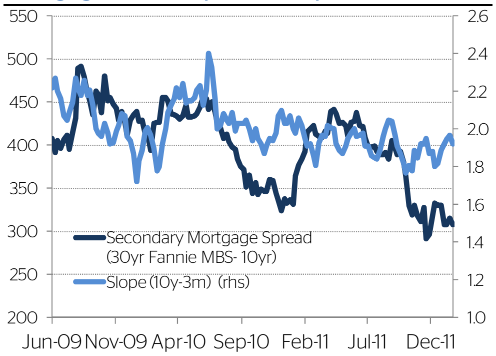
- Initial claims for unemployment insurance are approaching pre-crisis lows which support the recent favorable hiring data. Nevertheless, unemployment rates remain well above the Fed's long-run natural level target and thus a wait-and-see approach appears most likely.
- From the perspective of business activity, Operation Twist has coincided with an uptick in the ISM and capacity utilization. Although residential investment remains lackluster, the cost of residential investment is very low.
- The slightly improved optimism may not overcome serious structural problems in the housing market (high foreclosures, insufficient demand) that is weakening the link between monetary policy and the economy
- Equity markets, however, have responded favorably to highly accommodative Fed communications. Volatility has declined and recently the S&P 500 broke through the auspicious 1300 pt threshold

Table 1
Large Scale Asset Purchases (LSAP) Scorecard

| | Latest available | Operation Twist 10/11-present | Post QE2 11/10-10/11 | Recovery-preQE2 7/09-10/10 | Crisis 12/07-6/09 | Pre-Crisis 3/03-11/07 |
|---|---|---|---|---|---|---|
| 10yr Treasury (%) | 2.01 | 2.04 | 2.94 | 3.34 | 3.49 | 4.41 |
| 3mo Treasury (%) | 0.09 | 0.03 | 0.10 | 0.13 | 1.06 | 3.02 |
| Slope (bp) | 192 | 202 | 284 | 321 | 243 | 139 |
| 10yr Inflation Indexed (%) | -0.27 | 0.01 | 0.80 | 1.34 | 1.77 | 2.06 |
| Implicit 10yr Inflation exp. (%) | 2.28 | 2.04 | 2.15 | 2.00 | 1.72 | 2.35 |
| 5yr Breakeven inflation expectations (%) | 2.57 | 2.34 | 2.51 | 2.38 | 2.15 | 2.41 |
| VIX (Index) | 18.2 | 29.1 | 22.3 | 23.7 | 33.6 | 15.8 |
| S&P500 (Index)* | 1358 | 1235 | 1226 | 1093 | 1109 | 1462 |
| Real effective exchange rate ($, Index) | 98.4 | 98.6 | 98.3 | 102.3 | 102.9 | 111.2 |
| Corporate Spreads (BAA bp) | 315 | 321 | 288 | 287 | 409 | 201 |
| 30yr Mortgage sprd (bp) | 75 | 92 | 39 | 57 | 155 | 115 |
| 3M Libor-Treasury (bp) | 41 | 42 | 22 | 22 | 128 | 36 |
| Monetary aggregate M2 (yoy %) | 10.0 | 9.7 | 5.8 | 3.8 | 7.8 | 5.5 |
| Mutual Fund Flows Domestic ($M) | 35 | -2980 | -2213 | -8171 | - | - |
| Mutual Fund Flows Foreign ($M) | 1008 | -576 | 727 | 3954 | - | - |
| Mutual Fund Flows Taxable ($M) | 6463 | 3492 | 2259 | 27889 | - | - |
| Mutual Fund Flows Muni ($M) | 1733 | 984 | -901 | 4849 | - | - |
| Commercial Paper issuance ($bn) | 80.8 | 94.0 | 86.3 | 88.3 | 134.2 | 173.8 |
| Intial Claims (4wk avg) | 359 | 388 | 413 | 494 | 479 | 341 |
| Unemployment rate (%) | 8.3 | 8.7 | 9.1 | 9.7 | 6.8 | 5.2 |
| Private Payrolls (K monthly) | 257 | 202 | 167 | -7 | -396 | 119 |
| Consumer confidence (Index)* | 61 | 54 | 58 | 53 | 53 | 98 |
| Retail sales ex bldg, autos & gas (yoy %) | 5.2 | 5.6 | 5.8 | 1.6 | -0.6 | 5.3 |
| Industrial production (yoy %) | 3.3 | 3.7 | 4.5 | 0.2 | -7.0 | 2.3 |
| Capacity Utilization (%) | 79 | 78 | 77 | 72 | 75 | 79 |
| ISM Survey (Index) | 54.1 | 52.7 | 55.9 | 55.9 | 44.0 | 54.0 |
| Consumer Prices (12m %)* | 2.9 | 3.3 | 3.0 | 1.0 | 2.2 | 2.9 |
| Core Consumer Prices (12m %)* | 2.3 | 2.1 | 1.5 | 1.2 | 2.1 | 2.0 |
| Bank Mortgage loans ($bn)* | 2102 | 2071 | 2072 | 2106 | 2058 | 2005 |
| Bank CRE loans ($bn)* | 1427 | 1417 | 1463 | 1610 | 1673 | 1571 |
| Bank C&I loans ($bn)* | 1367 | 1333 | 1251 | 1264 | 1512 | 1414 |
| Bank Consumer loans ($bn)* | 1088 | 1091 | 1088 | 990 | 840 | 789 |

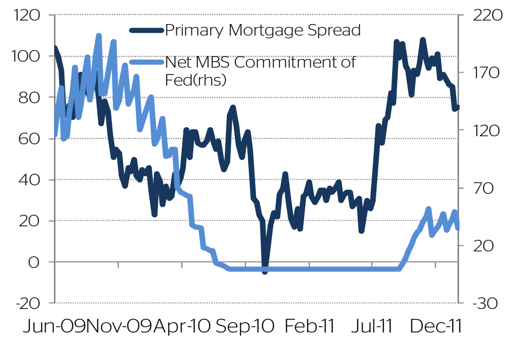
BBVA Research & Haver Analytics. * Pre-Crisis = Nov 2007

Chart 1
**Treasury Yield Curve Slope & Secondary Mortgage Market Spread(%, bp)**



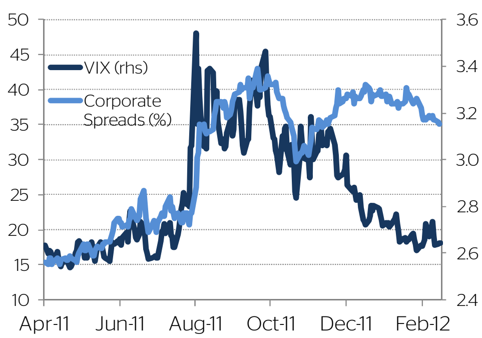

Source: Bloomberg, Haver Analytics & BBVA Research

Chart 2
**30yr Mortgage Spread & Fed MBS Net Purchases (bp & $bn)**



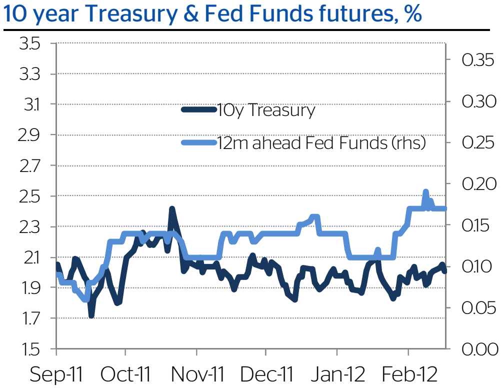

Source: Haver Analytics & BBVA Research

Chart 3
**Implied Volatility & Corporate Spreads (index & %)**



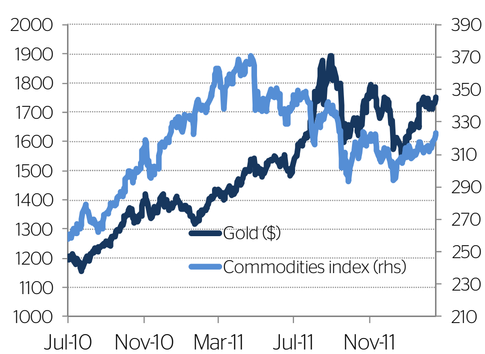

Source: Haver Analytics & BBVA Research

Chart 4
**10 year Treasury & Fed Funds futures, %**



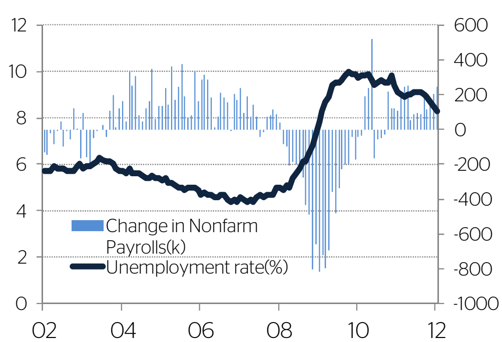

Source: Haver Analytics & BBVA Research

Chart 5
**Gold & Commodities**



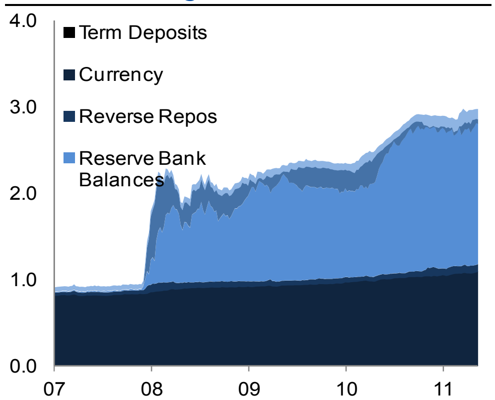

Source: Haver Analytics & BBVA Research

Chart 6
**Unemployment Rate & Nonfarm Payroll**



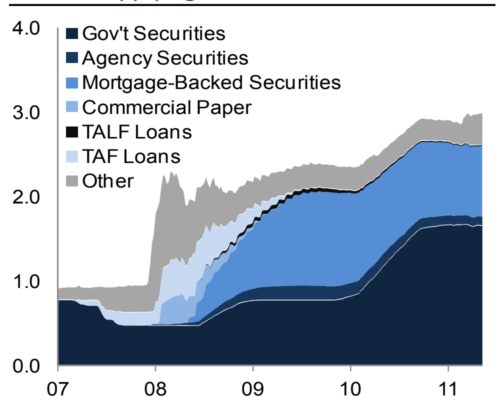

Source: Haver Analytics & BBVA Research

Chart 7
**Factors Absorbing Reserve Funds ($tr)**



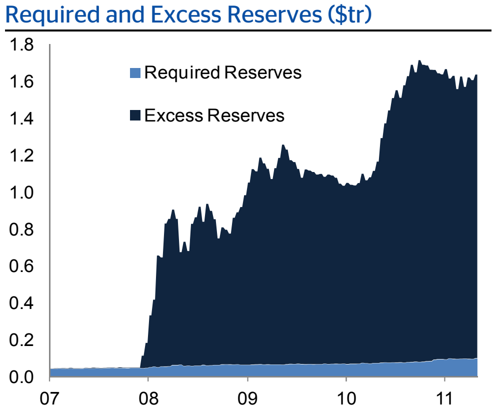

Source: Haver Analytics & BBVA Research

Chart 8
**Factors Supplying Reserve Funds ($tr)**



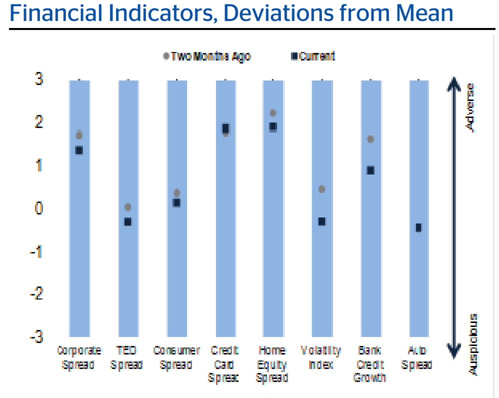

Source: Haver Analytics & BBVA Research

Chart 9
**Required and Excess Reserves ($tr)**




Source: Haver Analytics & BBVA Research

Chart 10
**Financial Indicators, Deviations from Mean**




Source: BBVA Research and Bloomberg

## Bottom line: Optimism grows, but vulnerability still exists

Current indicators suggest the Fed's maturity lengthening program has been associated with improvements in manufacturing, expanding private employment, low long-term interest rates and subsiding inflation. Given these auspicious signs, financial markets have responded with lower volatility and small equity market gains. Furthermore, mortgage spreads have declined during the Maturity Extension Program and 30yr mortgage rates remain at historic lows. Nevertheless, given the improving conditions and stable inflation, the Fed appears to have adopted a wait-and-see approach in the near-term. The short-term glow of optimism may fade as a result of the overhang from the European debt crisis and increased geopolitical risks. The economy remains susceptible to external shocks – similar to the oil shock of last year – and the Fed may have reached diminishing returns with asset purchases. These conditions may limit the economy's resilience over the year.