

Fed Watch

US

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Economic Analysis

US

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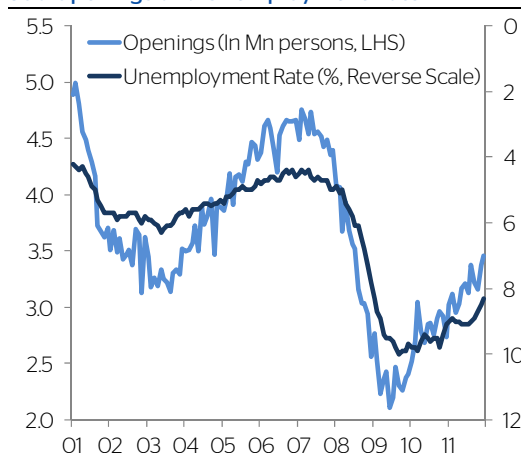
Don't fire until you see the whites of their eyes The Outlook for the Federal Reserve in April

- The FOMC will not step back with accommodation until it is clear there is high growth
- Only when it is evident that the dual mandate will be achieved in a reasonable amount of time will the Fed revisit the exit strategy
- Economic indicators, while more positive, contain too many caveats to risk another pullback
- The economy remains vulnerable to shocks and there is only a small margin for error, justifying holding on to a highly accommodative stance longer than expected by markets

Data improves, but growth is still not lofty enough to push through high unemployment

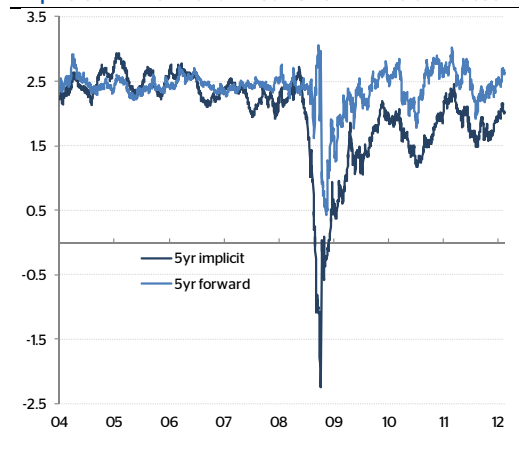
The improvement in the nonfarm payroll data is notable, but it does not arrive without caveats. With continued positive signals from the initial and continuing claims data, we expect another modest reading for the nonfarm payroll on Friday (BBVA: 200k, Consensus: 205k). The number of workers entering into employment, however, is not necessarily a sign of high economic growth to come and tends to be a lagging indicator. First, the unseasonably warm weather of the past quarter may have thrown off seasonal adjustments to the data by allowing employment that under normal seasons would not exist. Second, the slowdown in productivity, a reasonable trend after the formal end of a recession, may be leading employers to add workers as their firms fill out a full workweek. Some Federal Reserve governors, however, continually point to high levels of resource slack in the economy and note that recent job gains are the result of extremely low layoffs and quits rather than a sustained rise in openings. The amount of churn in the labor market is unusually low.

Chart 1
Job Openings and Unemployment Rate



Source: Haver Analytics & BBVA Research

Chart 2
Implicit and Forward Breakeven Inflation Rates

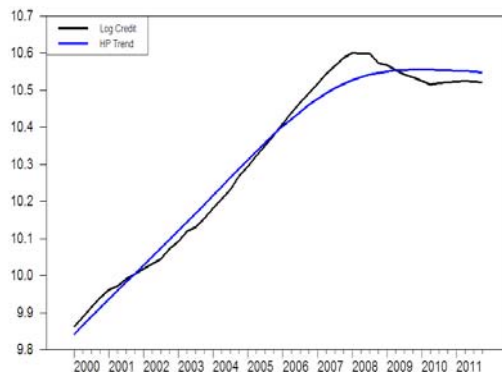


Source: Haver Analytics & BBVA Research

On the inflation side of the dual mandate, survey-based measures of inflation expectations remain low and wage pressures are not building. Employment costs are strongly related to expectations of inflation and hiring and thus in our opinion mostly serve to confirm a potential shift in inflation expectations. Since average hourly earnings are in nominal terms, adjusting for inflation places this particular measure of wage pressures in negative territory. The main problem with the outlook for inflation at the present time is the potential for a geopolitical shock to the price of oil. A temporary hit to oil prices during a quantitative easing program is not theoretically a problem for large-scale asset purchases (LSAP), but in practical and operational terms it is a problem. First, from a communication standpoint it is difficult to conduct an LSAP during an oil shock. Second, from a monitoring perspective it is similarly difficult to judge the outlook of inflation given components that are off-kilter from an oil shock. Thus, any oil shock will put a pause in the Fed's efforts while it monitors economic conditions for permanent or transitory effects. Additionally, the Fed would need time to gauge an oil increase's effect on growth.

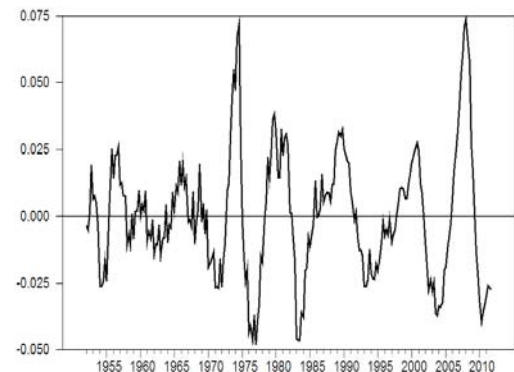
Some on the FOMC, mainly regional Fed presidents, fear high inflation as a result of expansionary balance sheet methods. In historical terms, expansion of the money supply would feed into high inflation through one of three channels: inflation expectations, bank lending, and commodity prices. As we have discussed above, inflation expectations are not unraveling. Although it would represent a means of extricating the US from its current slow growth, high bank lending has yet to emerge in the aggregate. While commercial and industrial lending is growing rapidly, real estate-related and consumer credit is growing slowly. Expanding this concept to the wider financial system, there is a huge "credit output gap" compared to the preexisting trend. Corporate bonds, in particular, are showing an unusual structural break. Thus we can argue that LSAPs have not created excessive bank lending or out-of-control inflation expectations, but prices of selected commodities, such as gold, are growing at rapid rates. The potential for a feedback loop between commodities and LSAP has been discussed, but research and comments by Federal Reserve officials suggests this is not a concern of the Fed.

Chart 3
Total Credit Output Gap by HP Filter, in Logarithms



Source: BBVA Research

Chart 4
Cyclical Component of Total Credit by HP Filter



Source: BBVA Research

Financial markets, however, have taken recent labor market indicators and the stem of quiet news from Europe and nudged slightly towards risk-taking. Nominal treasury and breakeven inflation rates from inflation-protected treasury yields trended upwards. Some of this represents reallocation towards riskier assets as a result of tail risk from Europe decreasing. Another part of this is re-pricing of yields as a result of slightly more positive growth prospects. This movement, however, is nearly exactly the situation of the Federal Reserve last spring, when growth prospects improved so strongly that the Federal Reserve began to discuss methods of reducing its balance sheet.

Don't fire until you see the whites of their eyes

This time around the recovery will be confirmed only when it is a fully-fledged recovery. We know that the extremes of the FOMC (Lacker and Evans) hold opposing views of appropriate monetary policy. However, the core members of the FOMC are adopting a steadfast stance this year. The main theme of their comments is that they want to see a clear and consistent message from the unfolding data. Testimony and speeches by Bernanke suggest he is not convinced by recent indicators in the labor market. Comments from Dudley imply that he is wary of major seasonal factors in the recent nonfarm payrolls data. These sentiments are best reflected in a recent speech by Rosengren: "...policy accommodation should only be removed once it is clear that the Fed's dual mandate can be achieved within a reasonable period of time." As such, the Federal Reserve is likely to maintain a highly accommodative stance until the economy is generating job openings at a rapid clip, enough to overcome the large credit output gap and revive investment in residential structures. The maintenance of this stance may also involve some new tools. For example, the decision to use sterilized bond purchases will be predicated on the state of the economy when Operation Twist ends. While the Fed believes that the stock of Treasury assets is more important than the flow of purchases, it remains unclear if financial markets will perceive the end of Twist as a lessening of accommodation. We view sterilized bond purchases as a tool for the Fed to use when inflation is above 2% and job growth turns lackluster.

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