BBVA RESEARCH

Fed Watch

US

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Economic Analysis

US
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FOMC Statement: June 19-20

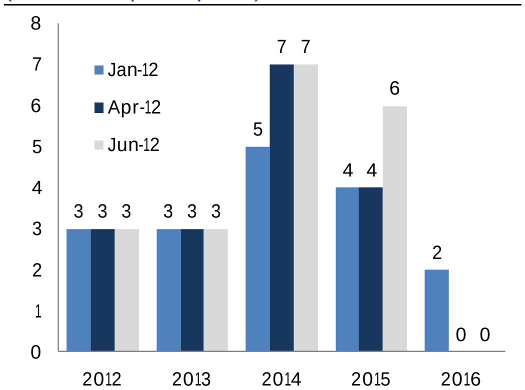
Pace of Labor Market Improvement in Focus

- Fed extended Operation Twist until year end by $267bn
- FOMC downgrades growth expectations, risks to outlook remain high
- Two new members voted for the first time

The FOMC Maintains a Highly Accommodative Stance

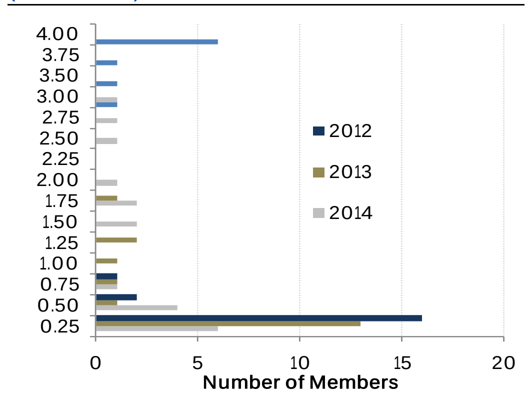
The Federal Reserve today downgraded their GDP forecast for the next three years, with the bulk of the revision in the short-term. The statement today used terminology like "very gradually" and "only slowly" for the first time to underscore participants' expectations for growth over the next two years. This downgrade of the forecast is somewhat stronger than expected, but it does bring the FOMC's forecasts closer to reality; we have often commented that their central tendency forecast was overly optimistic. Economic indicators released since April have been lackluster but hardly disastrous. As such, we believe that the FOMC is becoming increasingly concerned as to the effect of Europe on investment and employment in the US. The usual other persistent drags on the economy still exist – a depressed housing sector, household deleveraging, fiscal consolidation in government – but strains from Europe's sovereign debt crisis are looming larger month by month. Inflation is no longer a concern with oil prices pushing 12-month lows. As we expected, the pace of reduction in the unemployment rate is progressing insufficiently quickly for the FOMC and they extended Operation Twist until the end of the year by $267bn to continue a highly accommodative stance of monetary policy. One main benefit of extending this program is to buy time for the FOMC. Over the next six months, we will have a better idea of the outcome of elections, fiscal consolidation negotiations, and also a definitive read on the extent of employment creation. Thus, today's action leaves the FOMC ready to implement more stimulus if needed, even before the elections. Given that the US economy has already experienced a number of unorthodox monetary policies and flight to safety has resulted in low long-term lending rates, the FOMC may have to become increasingly more creative, possibly focusing on mortgage rates.

Chart 1
Appropriate Timing of Policy Firming
(Number of participants)



Source: Federal Reserve & BBVA Research

Chart 2
Target Federal Funds Rate Forecast
(Year-end %)



Source: Federal Reserve & BBVA Research

With regard to the extension of the maturity lengthening program, the FOMC and New York Federal Reserve announced that they would sell their remaining stock of 3-month to 3-year Treasuries, but securities maturing this year will be redeemed for cash. The composition of purchases is spread almost one-third each across the 6-8 years, 8-10 years and 20-30 years Treasuries with remaining maturity. The Fed continues to believe in the portfolio balance theory of large-scale asset purchases, which suggests that these programs push investors out of their "preferred habitat" and into other, more risky securities. A second theory less often mentioned by FOMC members is the role of a signalling channel by asset purchases. Under this theory, programs like Operation Twist communicate lower rates to the market rather than impact the portfolio balances of individual financial instruments. Regardless of these twin possible effects, an extended Operation Twist is likely to have limited additional impact on long-term rates.

According to the policy guidance released today by the FOMC, all the members are expecting the Fed Funds rate to be at or below 0.75% by the end of the year. This is a significant change compared to the previous FOMC meeting, where two participants were expecting the Fed Funds rate to be at or above 1.0% by the end of the year. The downward revision to the FOMC's outlook also resulted in some participants in reducing their pace of policy firming for 2014. The released graphic of appropriate timing of policy firming was little changed from the last meeting, except for the addition of two new members' sentiments.

Bottom line: A More United Fed, but with a Downgraded Economic Outlook

Today's FOMC meeting reveals a Federal Reserve that is more Chairman-centric, a prospect born mostly as a result of the addition of two members who will back the Chairman's position. The statement and updated forecasts also bring the Federal Reserve closer to our baseline, although the FOMC remains optimistic compared to our own expectation, especially for 2013-2014. We also believe that the Federal Reserve stands ready to implement more stimulus if economic conditions worsen or Europe strains financial markets. Our perspective on the FOMC's discussions moving forward is that they are considering the appropriate timing, method and size of additional stimulus, which will naturally depend on a variety of factors, especially the nature of the shock facing the economy. Overall, the probability of additional large-scale asset purchases has increased, but the exact trigger or composition of those purchases will depend on the evolution of the data and political events.

Table 1

Federal Reserve Forecast Comparison: June 20 FOMC Statement and Press Conference (Central Tendency)

June 2012 FOMC Projections				
	2012	2013	2014	Long-term
GDP, 4Q yoy % change				
Low	1.9	2.2	3.0	2.3
High	2.4	2.8	3.5	2.5
Unemployment rate, 4Q %				
Low	8.0	7.5	7.0	5.2
High	8.2	8.0	7.7	6.0
Core PCE, 4Q yoy % change				
Low	1.7	1.6	1.6	---
High	2.0	2.0	2.0	---

Apr 2012 FOMC Projections				
	2012	2013	2014	Long-term
GDP, 4Q yoy % change				
Low	2.4	2.7	3.1	2.3
High	2.9	3.1	3.6	2.6
Unemployment rate, 4Q %				
Low	7.8	7.3	6.7	5.2
High	8.0	7.7	7.4	6.0
Core PCE, 4Q yoy % change				
Low	1.8	1.7	1.8	---
High	2.0	2.0	2.0	---

Source: Federal Reserve & BBVA Research