U.S. Flash

Fedwatch: FOMC Minutes June 19-20

- **Hawkish wing of FOMC rehashes old arguments in new packaging, which underscores that doves need some time to reinforce consensus for more accommodation**
- **Housing market perks up in selected indicators, but spotty growth and generally-depressed conditions lead FOMC to discount it as a significant contributor to growth**
- **Fed to explore exact limit whereby Treasury purchases disrupt market functioning**

Today the Federal Reserve released the minutes of the FOMC meeting three weeks ago, which coincided with an expansion of the maturity extension program and a downgrade of the Fed's forecast for US growth. There are four key points to gather from the text of the minutes: 1) the composition of risks facing the US and the commensurate implications for policy, 2) the degree of brightness in the housing market and prospects for contribution from this sector to GDP, 3) the hawkish wing's rehashing of old arguments in a new light and 4) the question over the exact limit of large-scale asset purchases on the functioning of the Treasury market. Overall, the discussion in the minutes did not change our view of the growing likelihood of additional quantitative easing, but it does show that Bernanke has still a number of participants to convince before providing additional accommodation, though recent data continues to embolden his presumed position towards more action.

As is familiar to followers of Fedspeak, the US economy faces a number of persistent drags on growth (namely, consumer deleveraging, distressed housing markets, sluggish employment growth, to name a few), all of which have been exacerbated by increased risk aversion and worsened financial conditions as a result of European sovereign debt issues. Negotiations and fiscal conditions in Europe have put downward pressure on stock markets (and therefore wealth effects) and business confidence, but domestic fiscal conditions are also looming more prominently as we gravitate towards November elections and the deadline for automatic fiscal cuts. One new wrinkle in the Fed's story as compared to six months ago is a sharp drop in the price of oil which has subsequently caused downward revisions to private sector forecasts for inflation. Most participants view risks to inflation as roughly balanced. This last trend in inflation has now opened the door to potential new policy action given that almost all members saw unemployment as elevated relative to their desired level.

Secondly, while some housing indicators are perking up relative to extremely distressed levels, most FOMC participants believed the recovery in this sector would be only gradual and noted the spotty nature of recovery across geographic areas. Third, the text of the minutes show that the hawkish wing still has yet to abandon its theoretical opposition to viewing labor markets as rife with excess resource slack. Even with private forecasters lowering inflation forecasts due to the drop in oil prices, FOMC hawks still adamantly argue that inflation should be dropping more quickly if excess labor resource slack existed. To counter this argument, some participants argue that inflation declines are less responsive to resource slack due to downward nominal wage rigidity. The take-away from this discussion is that more data will be necessary to put this theoretical clash between participants aside.

Fourth, and most importantly and quite prudently, the FOMC is trying to discover how much large-scale asset purchases (LSAP) may be conducted before the liquidity and price discovery in the Treasury market is negatively affected. According to the minutes, "members generally agreed that such risks seemed low at present," thus showing that LSAP is a usable tool at present if economic conditions warrant more action. A recent speech by Williams noted that consumers were in a "defensive crouch" and a speech by Evans noted the importance of decomposing breakeven inflation rates into real interest rate risk and inflation risk. As such, we will closely be watching the continued evolution of consumption, employment and risk premia in Treasury markets going forward.

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