

Fed Watch

US

 Friday, February 15, 2013
 Economic Analysis

US

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QE Dashboard

Balancing Risk-on Risk-off Strategies for 1Q13

- Heightened policy uncertainty, recession in Europe, and the Fed's recommitment to longer-duration treasuries flattened the yield curve in 2012. Now, with markets in risk-off mode and Fed rates at historic lows, the slope has started to edge up.
- Monetary policy accommodation and strong corporate finances have led to a low volatility environment, with easing corporate spreads and implied market volatility.
- Although currently a low-risk concern, high money stock levels (M1) and increasing money velocity in a low-to-moderate growth environment could cause unwanted inflationary pressure.
- The Fed's concentrated efforts to lower the long-end of the yield curve could be disrupted if ongoing fiscal mismanagement increases economic uncertainty and thus the risk premium associated with long-term U.S. debt.

Table 1
 Large Scale Asset Purchases (LSAP) Scorecard

	QE3 (Hybrid) Latest available	Sterilized Purchases 10/11-12/12	Post QE2 11/10-10/11	Recovery 7/09-10/10	Crisis 12/07-6/09	Pre-Crisis 3/03-11/07
Inflation Indicators						
Slope (bp)	193	204	284	321	243	139
10yr Treasury (%)	2.0	2.1	2.9	3.3	3.5	4.4
10yr Inflation Indexed (%)	-0.6	-0.1	0.8	1.3	1.8	2.1
5yr breakeven Inflation expectations (%)	2.2	1.9	1.8	1.6	1.3	2.3
5yr forward Inflation expectations (%)	3.0	2.5	2.5	2.4	2.1	2.4
CRB Spot Commodity Prices(Index,1967=100)	485	506	519	421	392	316
West Texas Intermediate Spot Price(\$)	97.5	94.7	89.2	75.8	82.9	53.2
Consumer Prices (12m %)	1.3	2.4	3.0	1.4	2.0	3.6
Core Consumer Prices (12m %)	1.4	2.2	1.5	1.5	2.0	2.4
Risk Indicators						
VIX (Index)	12.6	22.5	22.3	23.7	33.6	15.8
S&P500 (Index)	1519	1310	1226	1093	1109	1219
FTSE Emerging Markets	752	706	773	682	599	868
US Dollar (Effective, broad Index)	99.5	98.8	98.2	102.3	102.8	111.2
US Dollar (Effective, emerging markets)	126.5	127.5	126.6	131.8	130.7	138.4
Corporate Spreads (BAA bp)	284	313	288	287	106	302
3M Libor-Treasury (bp)	20	36	22	22	243	139
Growth Indicators						
Initial Claims (4wk avg)	351	378	418	493	479	332
Unemployment rate (%)	7.9	8.3	9.1	9.7	6.8	4.7
Private Payrolls (K monthly)	166	155	167	-7	-396	75
Consumer confidence (Index)	59	63	58	53	53	88
Housing Starts	954	710	572	588	781	1818
Core Logic Home Prices (yoy%)	8.3	0.1	-4.4	-2.4	-14.1	9.0
Retail sales ex bldg, autos & gas (yoy %)	3.8	5.2	5.8	0.9	-0.6	5.3
Industrial production (yoy %)	2.3	4.1	4.4	0.2	-7.0	2.3
ISM Survey (Index)	53.1	52.2	55.9	55.9	43.9	54.1
Credit Markets						
Monetary aggregate M1 (yoy %)	12.3	9.0	6.0	3.9	7.6	5.5
Bank Credit (\$bn)	6195	6018	5870	5967	6081	4520
Bank Mortgage loans (\$bn)	2135	2104	2073	2107	2057	2011
Commercial Paper issuance (\$bn)	78	80	86	88	134	174
30yr Mortgage sprd (bp)	35	84	39	57	155	115
CP 3m spread (bp)	6	14	14	15	95	24

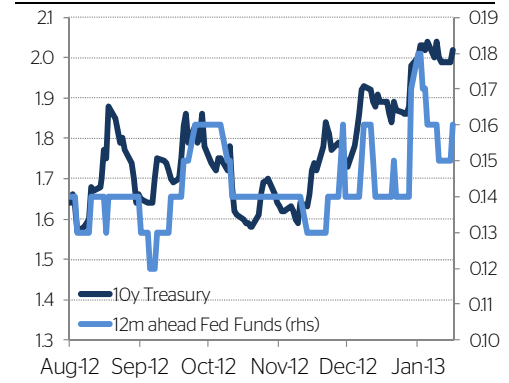
BBVA Research & Haver Analytics. * Pre-Crisis = Nov 2007

Chart 1
**S & P 500 & Treasury Yield Slope
(Index & bp)**



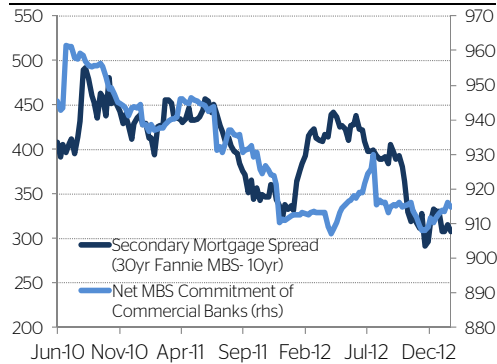
Source: Bloomberg, Haver Analytics & BBVA Research

Chart 2
**10-yr Treasury & Fed Funds Futures
(Yield & %)**



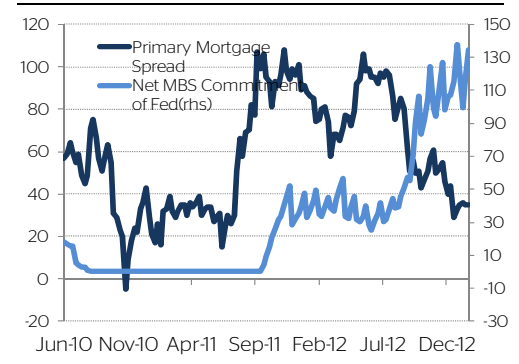
Source: Haver Analytics & BBVA Research

Chart 3
**Secondary MBS Spread & Net Commercial
Bank MBS Commitment**



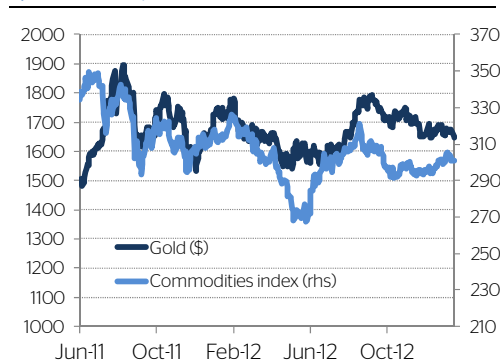
Source: Haver Analytics & BBVA Research

Chart 4
**30yr Mortgage Spread & Net Fed MBS
Purchases (bp,\$bn)**



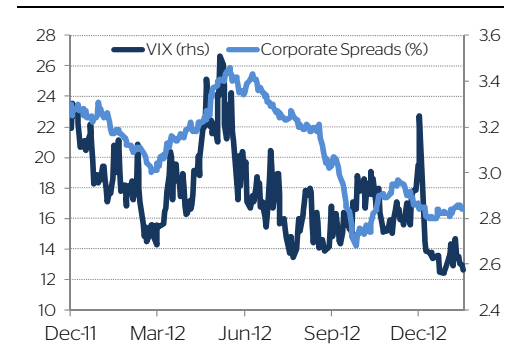
Source: Haver Analytics & BBVA Research

Chart 5
**Gold & Commodities
(\$US & Index, 1967=100)**



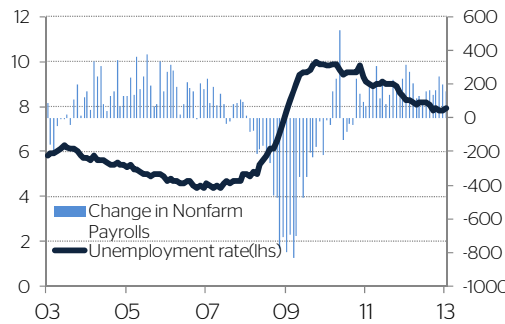
Source: Haver Analytics & BBVA Research

Chart 6
**Implied Volatility & Corporate Spreads
(Index & %)**



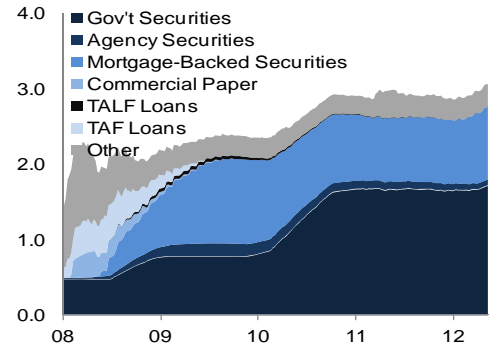
Source: Haver Analytics & BBVA Research

Chart 7
Unemployment & Nonfarm Payrolls (% & K)



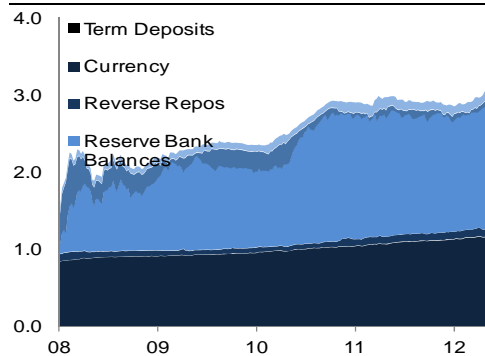
Source: Haver Analytics & BBVA Research

Chart 8
Factors Supplying Reserve Funds (\$tr)



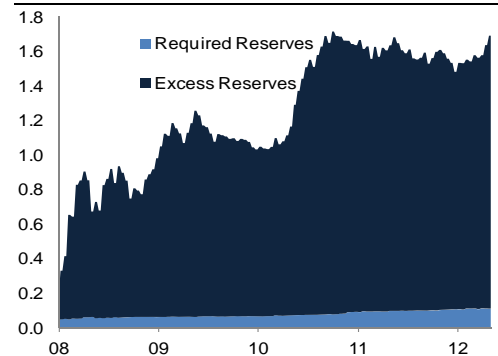
Source: Haver Analytics & BBVA Research

Chart 9
Factors Absorbing Reserve Funds (\$tr)



Source: Haver Analytics & BBVA Research

Chart 10
Required and Excess Reserves (\$tr)



Source: Haver Analytics & BBVA Research

Bottom line: Economic fundamentals improve with greater Fed clarity

Successive steps by the Fed to clarify that accommodative monetary policy will persist for a prolonged period - additional quantitative easing and explicit unemployment rate and inflation targets - has assuaged market concerns that the end of QE3 is around the corner. The stronger commitment appears to have aided financial markets' willingness to search for higher-yielding financial products. Reduced federal austerity and policy uncertainty, along with strengthening consumer demand, have also reinforced the Fed's efforts to lower aggregate uncertainty. The risk-off environment, exemplified by the pre-recessionary levels of implied market volatility (VIX) and corporate spreads, may not reflect actual market risk given that Europe remains in recession, fiscal issues in the U.S. are unresolved, and the sustainability of U.S. growth is still in question.

Ultimately, lower market risk perception did not translate into sustainable economic improvements. An unemployment rate of 7.9% remains 1.4pp above the explicit Fed target, and our baseline scenario assumes the unemployment rate will remain above the quantitative threshold through 2014. Moreover, near-term inflationary concerns are muted, and the level of fiscal austerity is still highly uncertain. While there are upside risks to long-term yields associated with the credibility of U.S. debt and fiscal uncertainty, we ultimately believe risks are balanced and that the Fed will continue to provide high levels of accommodation for the foreseeable future.

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