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Fed Watch

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Economic Analysis

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Chairman Bernanke's Testimony to Congress

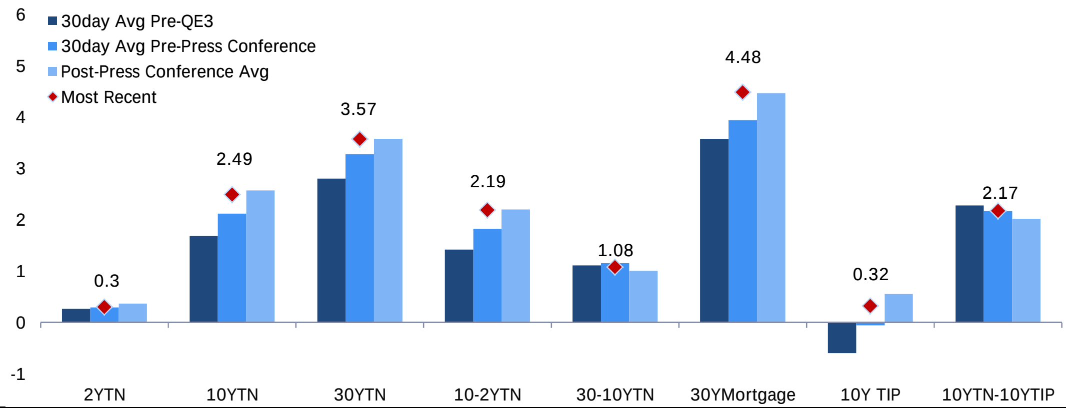
Report Incorporates Many Dovish Twists to Restore Confidence

- Chairman restated the timeline for QE3 putting dovish spin to frame investors expectations
- Fed balance sheet will remain high for extensive period of time
- Our expectations for the FOMC policy remain unchanged

In his Semiannual Monetary Policy Report, Bernanke restated the monetary policy outlook that grabbed markets attention during his June 19th press conference. In line with FOMC consensus, the plan for QE3 is to "moderate monthly pace of purchases later this year" and to "continue to reduce the pace of purchases in measured steps through first half of next year, ending them around midyear."

Bernanke also reemphasized the importance of "cumulative progress" in the economy since the start of QE3 in 4Q12, rather than solely relying on the most recent economic news. Nevertheless, the testimony accentuated existing risks to economic growth and the labor market from fiscal restraint and lower-than-expected inflation. Moreover, Bernanke reassured markets that if the path of economic activity were to diverge from FOMC projections, "the current pace of purchases could be maintained for longer." Furthermore, he stated the Committee's preparedness "to employ all of its tools, including an increase the pace of purchases." The dovish undertone boosted equity and bond prices. The S&P500 increased 4.65 points to 1,680.91, a gain of 0.3% while the yield on the 10-Year Treasury Note declined 4 basis points to 2.49%. The testimony also stressed that asset purchases and the federal funds rate are "two distinct yet complimentary policy tools," and that QE3 is "by no means on a preset course."

Chart 1
QE3 Impact on Interest Rates (%)



Source: Federal Reserve & BBVA Research

In relation to the exit strategy, Bernanke noted the FOMC plans to keep the Fed's stock of Treasuries and agency securities "off the market" and to continue reinvesting the proceeds from the policy. Hence, the Fed balance sheet will remain elevated for many years and policy normalization will take longer than what most analysts expect. For example, if the Fed abstains from selling any securities, it will take around ten years for the ratio of total Fed assets to GDP to return to pre-crisis levels. Bernanke reassured the soundness of this policy, highlighting that even if the issuance of treasuries decrease, the Fed's holdings would remain a very small portion of the total stock.

In the Q&A session, Bernanke attributed the recent hike of mortgage rates to the strong labor market report as well as to an unwinding of "excessively risky positions." The FOMC is closely monitoring the housing market and equity prices for potential risks because of recent increases in mortgage rates and the search for yield.

Bottom line: QE3 timeline remains unchanged, with tapering to be announced later in 2013

Today's testimony reemphasized the data-driven nature of QE3 and stressed that the Committee's plans for winding down QE3 remains on course. However, Bernanke was cautious to keep policy flexibility by stating that the asset purchase program can be dialed up if the fiscal and global restraints prove to be stronger than expected. This could also be a reaction to the sharp increase in interest rates over the past two months, and thus was an attempt to promote a more gradual correction in long-term yields. Despite the dovish tone of the testimony, we maintain our baseline scenario of Fed tapering later in 3Q13 and ending the program in 2Q14, when the unemployment rate has dropped to around 7%.