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# Fed Watch

US

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Economic Analysis

US

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## Ahead of September 17 – 18 FOMC Meeting

### Start of QE3 Tapering to Be Announced on September 18th

- **Low inflation rate was at the center of FOMC discussion on tapering, while labor market improvement was perceived satisfactory and took a back seat.**
- **Projection of tapering to be announced in September 18th Statement.**
- **Delaying the announcement to December will increase the cost of QE3, decrease credibility and increase financial market volatility.**

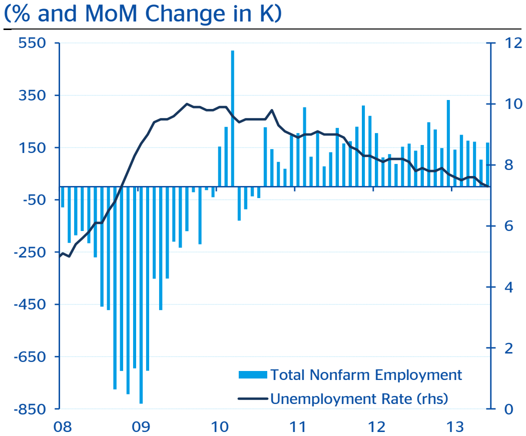
Inflation has overtaken labor market conditions as center stage in Fedspeak prior to the pre-meeting blackout period, and will become the single dividing factor among FOMC members when deciding on when to start scaling down QE3 purchases.

The speeches of Evans (Federal Reserve Bank of Chicago), Kocherlakota (Federal Reserve Bank of Minneapolis) and Williams (Federal Reserve Bank of San Francisco) emphasized that inflation has been missing the FOMC target by more than 0.5% for the last 6 months and that they were equally worried about an inflation rate that is either too low or too high relative to the 2% objective.

In contrast, the cumulative improvement in the unemployment rate since the start of QE3 in September 2012 is already factored into the decision to taper in September. The August decline of the unemployment rate to 7.3% compared to 8.1% from one year ago (August 2012) is viewed as satisfactory progress towards the full employment goal. However, the most dovish members will stress that monthly gains in nonfarm payroll has been weak and missed the 200K mark for the 6 month average.

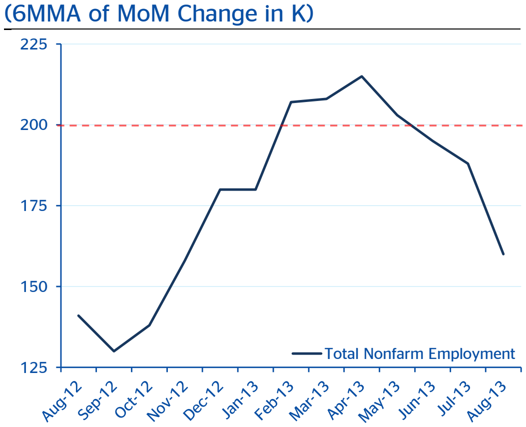
With only 2 speeches by FOMC voting members, Evans suggests delaying tapering until December in order to have a clearer picture regarding 3Q13 GDP growth prospects and assurance that low inflation is transitory. George's view is familiar and refers to the QE3 tapering as an overdue task. Whether the September 18th FOMC policy statement announces tapering or not, we should not expect a unanimous vote for the action.

Chart 1
**Unemployment Rate and Nonfarm Payrolls (% and MoM Change in K)**




Source: BLS & BBVA Research

Chart 2
**Nonfarm Payrolls (6MMA of MoM Change in K)**




Source: FRB & BBVA Research

## Will the September FOMC Statement Announce Tapering?

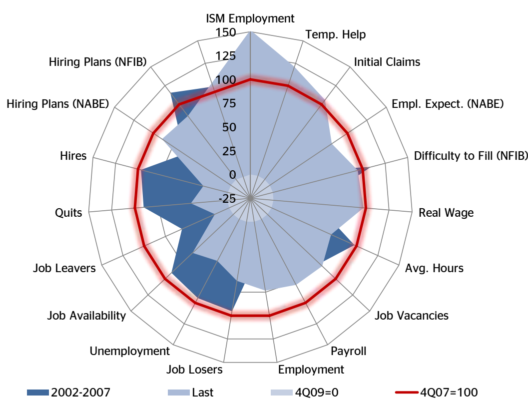
| | |
|---|---|
| Weaker benefits from QE3 while costs are rising | Reduce uncertainty to stabilize long-term Treasury rates |
| A more favorable timeframe to wind-down LSAP | Higher credibility of FOMC policy announcemnt |

**Why Fed will Start in September**

### *Weakening Benefits of QE3*

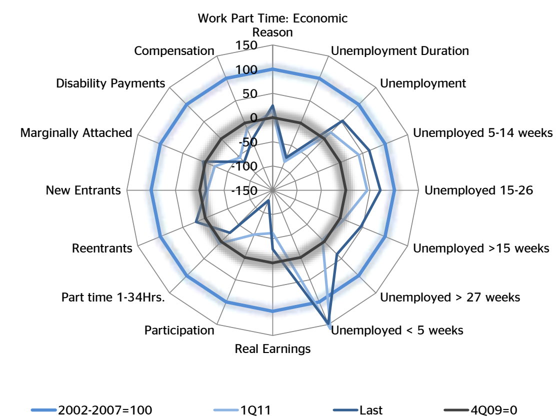
Further benefits from continuing the large scale asset purchases (LSAP) program are questionable and the scale is tipping away from the efficacy of the purchases with costs about to outweigh the benefits (also see US Economic Outlook). A snapshot of the labor market highlights uneven improvements and existing problems. The relative importance of structural unemployment is increasing. Remarkably, several labor utilization indicators have not improved from their trough levels, while the participation rate continues to decline and stands at its lowest level in almost four decades.

Chart 3
**Labor Market Outlook**
**(%)**




Source: BLS, DoL, NABE, NFIB, ISM & BBVA Research

Chart 3
**Labor Market Utilization**
**(%)**




Source: BLS, DoL, NABE, NFIB, ISM & BBVA Research

### *Reducing Uncertainty Will Stabilize Long-Term Treasury Rates*

Reducing the uncertainty around the path and the pace of tapering QE3 should provide relief to rising long term yields. Bond market participants have already priced in FOMC tapering in their expectations, probably assuming a much faster pace since market participants tends to discount worst-case scenarios (Caballero and Krishnamurthy, 2008). Since LSAP involves long-term assets whose prices are highly sensitive to the expectations of future monetary policy, providing a clear path for scaling down LSAP should serve to remove uncertainty and thus stabilize the treasury yield curve. Furthermore, communicating through a rule versus discretionary announcements should decrease the term premium of long-term rates which was the cause of the recent continued increase in long-term yields (Krishnamurthy and Vissing-Jorgensen, 2013).

The 10-Year Treasury Note closed at 3.01 % last Thursday, reaching its highest yield since July 8, 2011. Announcing taper would take some pressure off interest rates which could bring a slight downward movement at the back end of the yield curve as the market adjusts to more certainty.

### *Delaying the Start of QE3 Tapering will Result in a Steeper Pace for the Wind-down Process*

Bernanke and FOMC members outlined two key periods regarding the future path of QE3: the start of scaling down LSAP and the end of asset purchases. Stepping back to June 19th, in the post FOMC meeting press conference Chairman Bernanke stated:

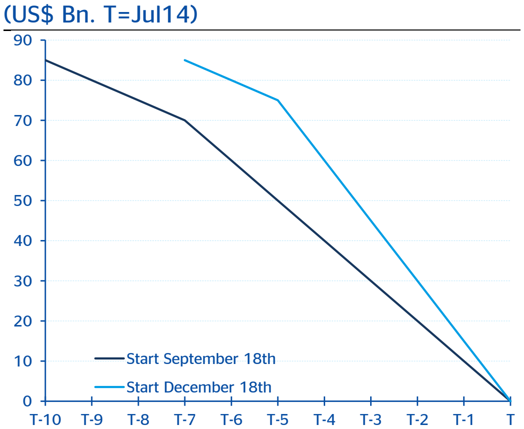
*"…the Committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year. And if the subsequent data remain broadly aligned with our current expectations for the economy, we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear."*

Of the 3 remaining FOMC meetings this year, only the September 17-18th and the December 17-18th meetings end with the Chairman's press conference. Given the relevancy of the decision these dates would be appropriate for such a major policy announcement (FOMC Minutes July 30-31). Notably, the end of LSAP is currently pinned to mid-2014. Under the assumption that the unemployment rate will continue to decline and reach 7% by mid-2014, announcing the start of a scaling down in LSAP in December would result in a steeper pace for the wind-down process.

### *Credibility of Commitment to the Policy Announcement*

Another downside to the FOMC announcing the scaling down of LSAP in December compared to announcing in September is whether the announcement and subsequent press conference by the current Chairman would have a credible reception by investors. Since the Chairman and the composition of the FOMC voting members will be much different in 2014, there is a higher risk of perception regarding the commitment of the FOMC to the measured reduction of LSAP. The nominee for Fed Chairman will likely be already known to the public by December.

Chart 5
**Implied Pace for LSAP Taper (US$ Bn. T=Jul14)**




Source: BBVA Research

Chart 6
**2013 FOMC Voting Members and Terms**

| | | |
|---|---|---|
| Chairman | Ben S. Bernanke | Term as Chairman ends January 31, 2014 |
| Vice Chair | Janet L. Yellen | Term as Vice Chair ends October 4, 2014 |
| Governor | Elizabeth A. Duke | Resigned effective August 31, 2013 |
| Governor | Daniel K. Tarullo | Term ends January 31, 2022 |
| Governor | Sarah Bloom Raskin | Nominaed for U.S. Treasury Deputy |
| Governor | Jeremy C. Stein | Term ends January 31, 2018. |
| Governor | Jerome H. Powell | Term ends January 31, 2014 |
| New York | William C. Dudley | Permanent seat |
| Chicago | Charles L. Evans | Rotation change to Philadelphia |
| Boston | Eric S. Rosengren | Rotation change to Cleveland |
| St. Louis | James Bullard | Rotation change to Dallas |
| Kansas City | Esther L. George | Rotation change to Minneapolis |

Source: FRB & BBVA Research

### Bottom Line: Timeline remains unchanged, with tapering to be announced on September 18th

Nowadays, FOMC forward guidance has evolved from forming market expectations on the federal funds rate to additionally guiding market expectations on LSAP, which directly affects the current term premium of long term interest rates. The delay of a tapering announcement by the FOMC would increase uncertainty and continue putting upward pressure on long term interest rates. It would create further volatility in the equity and bond markets, given that investors' expectations are mostly settled on a September FOMC announcement to taper. Thus, we maintain our projection that the FOMC will announce LSAP tapering in its September 17-18th meeting and mark a timely start to prepare for further policy normalization in 2015.

Table 1
Federal Reserve Commentary, Ahead of FOMC Meeting

| | Esther L. George<br>FRB Kansas City<br>September 6, 2013 | Charles Evans<br>FRB Chicago<br>September 6, 2013 | Narayana Kocherlakota<br>FRB Minneapolis<br>September 4, 2013 | John C. Williams<br>FRB San Francisco<br>September 4, 2013 |
|---|---|---|---|---|
| **QE3** | **A decision to reduce the Federal Reserve's monthly asset purchases would be appropriate** at [September] meeting, as would clearer guidance about the path forward. It is time to begin a gradual— and predictable—normalization of policy. | …to start the wind-down, it will be best to have confidence that **the incoming data show that economic growth gained traction during the third quarter** of this year and that the transitory factors that we think have held down inflation really do turn out to be transitory. | **These forecasts imply that the Committee is failing to provide sufficient stimulus to the economy.** Indeed, the FOMC's own forecasts suggest that **it should be providing more stimulus to the economy, not less.** | I view Chairman Bernanke's timetable to still be the best course forward…**when and how we adjust our purchases will depend crucially on what the incoming data tell us** about the outlooks for the pace of improvement in the labor market and movement towards our inflation goal. |
| **Inflation** | Although official measures of inflation are currently below the Fed's longer-term goal of 2 percent, **the inflation rate is likely poised to move closer to the target** based on gasoline and food prices, which have moved higher over the past few months. | it could take **a long time for us to return to our 2 percent inflation objective**, and I will be monitoring our progress closely when making my decision about appropriate monetary policy. | …personal consumption expenditure inflation—including food and energy—**is running well below the Fed's target of 2 percent** | Over the past year, our preferred inflation measure rose at a 1.4 percent rate, **well below our 2 percent target**. I expect inflation will gradually climb back towards our 2 percent longer-run target over the next few years. |
| **Unemployment** | At this pace of improvement, **the labor market is creating enough jobs to continue bringing down the unemployment rate**. | Payrolls remain on the order of about 5 million below where they should be. In addition, an unusually high number of productive, potential workers are not even looking for jobs right now. | In July, the unemployment rate was 7.4 percent—**much higher than the FOMC's current assessment of the longer-run normal unemployment rat**e, which is between 5.2 percent and 6 percent. | With the economy continuing to grow and add jobs, I expect the unemployment rate to decline gradually over the next few years. |
| **Long-term Rates** | To the extent that longer-term interest rates move higher as the pace of purchases slows, **the economy is positioned to benefit from modestly higher longer-run interest rates.** | Our asset purchases of U.S. Treasuries and agency mortgage-backed securities (MBS) provide additional accommodation by further lowering longer term interest rates. | …buying long-term assets and keeping short-term interest rates low—are designed to stimulate spending by households and firms, and thereby push up on both prices and employment. | Recently, **longer-term rates have risen as investors prepare for the eventual normalization of monetary policy**. But they are still quite low by historical standards. |
| **Speech Highlights** | For example, an appropriate next step toward normalizing monetary policy could be to reduce the pace of purchases from $85 billion to something around $70 billion per month, then have purchases going forward split evenly between Treasury and agency-MBS securities. | In answer to the question of are we there yet, I decidedly say no. It is not yet time to remove accommodation. | But current monetary policy is typically thought to affect the macroeconomy with a one- to two-year lag. This means that we should always judge the appropriateness of current monetary policy in terms of what it implies for the future evolution of inflation and employment. | But the time is approaching when our economy will have enough momentum on its own without the need for additional monetary stimulus. This is undeniably welcome news. |

Source: Federal Reserve & BBVA Research

### *References*

Caballero, Richard J. and Arvind Krishnamurthy, 2008, "Collective Risk Management in a Flight to Quality Episode," *Journal of Finance*, 63(5), pp. 2195-2236

Krishnamurthy, Arvind and Annete Vissing-Jorgensen, 2013, "The Ins and Outs of LSAPs," working paper