

Fed Watch

US

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Economic Analysis

US

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Ahead of June 18 – 19 FOMC Meeting

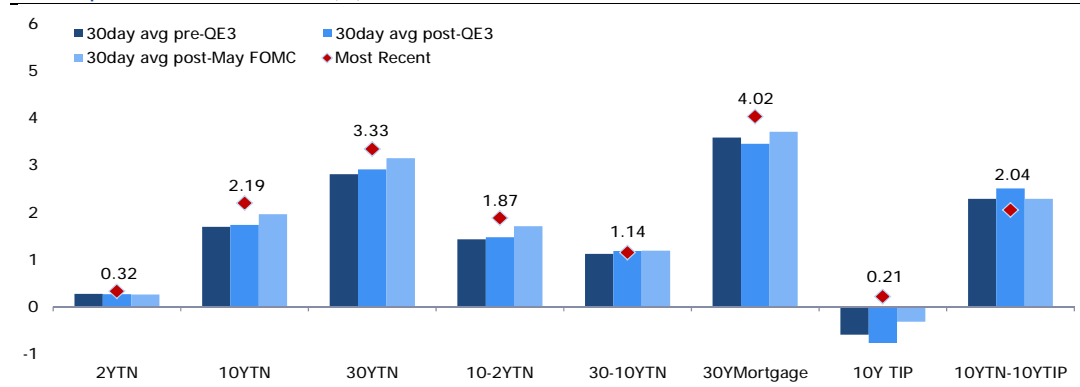
The Challenges Facing the Committee Members in the Upcoming Meeting

- Internal agreement on timing to scale back asset purchases and further clarity in FOMC communication are necessary steps forward.
- Exit principles and policy normalization: is new guidance necessary?

In a time when forward guidance is the centerpiece of FOMC policy, the lack of clear communication and internal disagreement within the Committee send confusing signals to financial markets. The government bond market reacted with a significant increase in yields including the 2-year treasuries, which tracks Fed's rate policy expectations. Although volatility also increased because of Bank of Japan's decision to refrain from announcing new monetary easing measures, the FOMC is likely looking carefully how to avoid a similar reaction in coming months. Thus, part of the discussion in the next FOMC will focus on how to better prepare markets for the possible scale back of the monthly asset purchases.

What is currently evident is that there will be no dialing up or down of the pace of asset purchases in the next meeting. In our view, when contrasting improvements in the labor market and the low inflation rate readings of the last several months, the best option will be to keep the current pace of asset purchases. This perspective was well summarized by Bullard (Voting FOMC Member, Federal Reserve Bank of St. Louise, June 10, 2013) that "low inflation may give the FOMC more leeway to continue its aggressive asset purchase program," while improved labor market conditions suggest that "the Committee could slow the pace of purchases." On the other hand, some of the dovish members of the FOMC, such as Lockhart (Federal Reserve Bank of Atlanta), Williams (Federal Reserve Bank of San Francisco), Evans (Voting Member, Federal Reserve Bank of Chicago) as well as Chairman Bernanke, are open to the discussion of scaling back the pace of purchases sometime in the summer or early fall. Most importantly what is emphasized continuously by the Committee members' individual interviews and speeches is, as Lockhart stated, "it is not an exit from asset purchases, it is simply recalibration of the amount of purchases." This is a key element within the communication strategy, given that many market participants still fail to understand the difference between dialing down asset purchases and tightening monetary policy. While the former may be around the corner, the latter is still several quarters away.

Chart 1
QE3 Impact on Interest Rates (%)



Source: Federal Reserve & BBVA Research

Another communication dilemma facing FOMC members is how to proceed regarding the dated "Exit Strategy Principles" outlined in June 2011. As Committee members realize the necessity to signal their competence in delivering a suitable exit, the last meeting minutes revealed the true challenge of stirring market expectations with regard to the policy normalization process. The two options on the table are either 1) reaffirming that the broad principles outlined in June 2011 still apply while acknowledging that some components of the old strategy will need to change due to recent events, or 2) issuing revised principles for the normalization process. Both options carry drawbacks. For the first option, issuing a broad reaffirmation without giving any details of what may change will likely not convey that the Fed has the tools and the plan to normalize. While for the second option, outlining details for normalization early without knowing the final outcome of QE3 and the environment in which the policy will be implemented, will likely bring further alterations to the plan and hurt the Fed's reputation. Before the last meeting adjourned, the Chairman directed the staff to "to undertake additional preparatory work on the issue for Committee consideration in the future," while the near future likely outcome is the FOMC providing a set of broad principles without detailed information on the steps to anticipate. Therefore, the preferred course of action will be to guarantee the FOMC enough flexibility on either direction and also in the magnitude of the potential dialing up/down of asset purchases.

Bottom line: No changes to the highly accommodative monetary policy are currently expected

After the FOMC June 18 - 19 meeting, the FOMC will not announce a change to the ongoing monthly pace of asset purchases of \$85bln, reflecting the lack of agreement on what evidence would be necessary for the scale back in purchases. The statement will reveal more on the stance of the Committee regarding the labor market outlook and the inflation path, with still some cautiousness regarding the sustainability of the recovery given the headwinds from fiscal policy. In our baseline scenario, we project the FOMC will start dialing down asset purchases in late 3Q13, and that QE3 will come to an end in 1Q14. However, this is data-dependent and thus subject to elevated uncertainty. We also expect the Fed to be particularly careful in providing more transparent communication throughout the long term policy normalization process and the use of forward guidance as a key policy tool during the exit strategy.

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