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Fed Watch

US

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Economic Analysis

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Ahead of the June 17th - 18th FOMC Meeting

Exit Strategy to Fit the Size and Composition of Balance Sheet

- **FOMC plans to continue principal reinvestment after zero bound lift-off**
- **Lifting the zero bound is a possible pre-condition for inflation to pick up**
- **Fed is expected to stay on track with another $10bn QE3 taper**

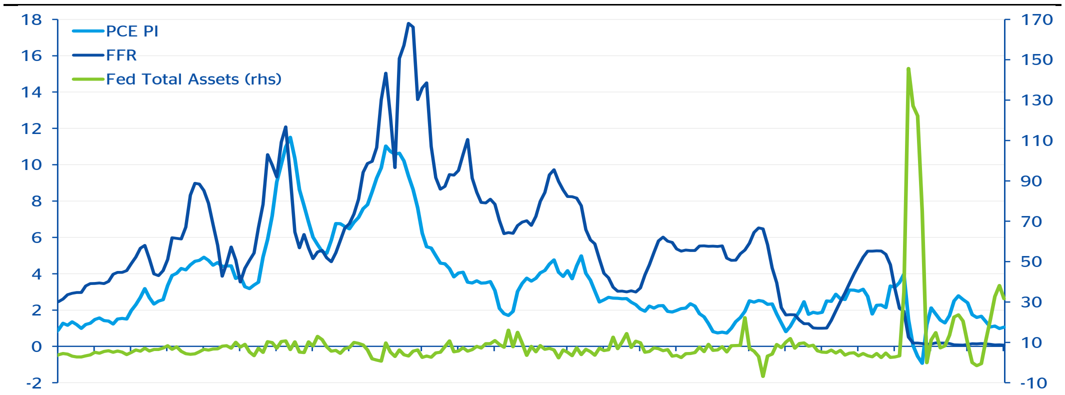
The center-stage of the 2014 FOMC discussions so far has been the methods of successful crafting of forward guidance and the exit strategy. The poised market reaction to the gradual reduction of QE3 has put tapering on auto-pilot, thereby shifting policy makers' attention to succeeding challenges. The FOMC has obtained a valuable understanding of financial market reactions to tapering communication and the implementation of tapering – concluding that markets react positively to transparent, gradual and predictable changes. Thus the FOMC's main challenge in communicating the timing of policy rate lift-off, the trajectory of rates after the lift-off, and means of policy normalization, is to set market expectations on the right path with timely and clear communication. As stated in the last minutes: communication should start "well before the first steps in normalizing policy become appropriate," and should "enhance the clarity and credibility of monetary policy."

Policy normalization could also potentially carry further benefits in achieving the Fed's 2% target inflation rate. Confirming our contention (Economic Watch) that near zero policy rate might be one of the factors pulling the inflation trend down, Plosser (FRB Philadelphia) stated on May 30th:

"There are other views out there, about why inflation is too low. There are some people to say we kept interest rates too low for too long. And the only way to have nominal interest rates that is real plus expected inflation at zero is to have negative inflation."

Plosser further rationalized that that there is much uncertainty on how the economy works in an environment where interest rates are kept "so low for so long, and there are things that can surprise us about the outcome, what we know and how things work at zero bound."

Chart 1
Federal Funds Rate, Balance Sheet, and PCE Inflation (YoY, %)



Source: FRB, BEA & BBVA Research

The policy speeches that concluded the Fedspeak prior to the Fed's blackout period carried a clear message that the time for policy normalization is nearing, that the FOMC has new tools on hand, and it has done its homework on how to maintain control over short-term interest rates with the current size and composition of its balance sheet. "The FOMC is much closer to its goals than at any time in the past five years," said Bullard (FRB St. Louis), while Rosengren's (FRB Boston) speech was titled: "New Monetary Policy Tools: What Have We Learned?"

Meanwhile the timing of the first rate hike and the path of Federal funds rate remains data dependent. The Fed set expectations such that there will be a considerable period of time between the end of asset purchases and the lift-off of the near-zero policy rate, but exactly how long the "considerable period of time" will be has inherent uncertainties. The FOMC members' conversation over discretionary policy vs. rule-like policy stumbled. Considering that the Federal funds rate is expected to stay below equilibrium with a slow pace of policy tightening, the pro-discretionary doves in the FOMC gained the upper hand. The larger number of current Committee members' views can be rightfully reflected by Rosengren's statement that "it is important to avoid binding specificity about future actions, since policies should be responsive to actual conditions as clarity emerges about the strength of the economy and the impact of various tightening tools."

The months of Fed discussions on exit strategy delivered its likely consensus outcome regarding the changes that are necessary to introduce to the Exit Strategy Principles outlined in the June 2011 FOMC meeting minutes. The expected modifications to the previously formalized exit strategy were summarized in Dudley's (FRB NY) speech on May 20th.

The main monetary policy tool will certainly remain the short-term interest rate, and not the discretionary shifts in the balance sheet. However, Dudley referred to the plan of ending reinvestment policy prior to the zero bound lift-off as risky, since it might bring premature tightening of financial conditions and "foreshadow the impending lift-off date for rates in a manner inconsistent with the Committee's intention." Thus the reinvestment is expected to continue past the first Federal funds rate hike, and the balance sheet levels would be maintained high through the first steps of policy tightening. Dudley emphasized that "delaying the end of reinvestment puts the emphasis where it needs to be—getting off the zero lower bound for interest rates."

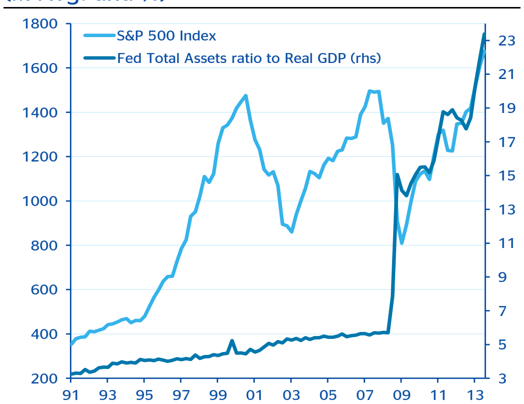
	June 2011 Exit Strategy	Modifications Expected
1	Cease reinvesting some or all payments of principal on the securities holdings	Ending reinvestments as an initial step risks bringing forward any tightening of financial conditions and is not viewed as the best strategy
2	Modify its forward guidance on the path of the federal funds rate	Forward guidance on the future path of the policy rate is believed to serve as a keystone to policy normalization
3	Initiate temporary reserve-draining	New tools, such as the overnight fixed rate reverse repo facility, are tested in addition to the standard interest rate on excess reserves, to set a floor under money market rates
4	Begin raising the target federal funds rate, with changing the level or range of the federal funds rate target to be the primary means of policy adjusting	Changes to short-term rates will remain the primary means for adjusting monetary policy post-liftoff
5	Sales of agency securities, with the pace of sales to be aimed at eliminating the holdings of agency securities over a period of 3 to 5 years	The balance sheet would shrink as Treasury securities matured and mortgages were prepaid, but outright agency MBS sales are no longer contemplated

There is however a divide between FOMC doves and hawks regarding the long-term monetary policy framework. Hawkish FOMC members advocate for setting a goal of returning the Fed balance sheet close to the pre-crisis level, and a composition of short-term securities, as well as the use of the corridor system to control short-term interest rates. Thus they insist on having a clear idea on the final destination, in other words, where the policy normalization is heading, in order to formalize how to get there. At the same time, members with a dovish stance, for example Dudley, argued to refrain from "putting the cart far before the horse," insisting on focusing on tools to conduct monetary policy during the transitional phase while keeping the options open for the long-term monetary policy framework. Likewise, Rosengren advocated additional benefit in maintaining a large balance sheet that would provide the Fed with "continuing options for impacting long-term interest rates and the spread between mortgage-backed securities and U.S. Treasury securities."

"Longer term, the issue will be whether to return to the type of corridor system that was in place prior to the crisis or to instead to stay with the type of floor system that will likely be the type of regime that is in place as the balance sheet gradually normalizes. I expect that the choices made over the near-term can be implemented in a way so as not to forestall either a corridor or a floor system over the longer term." Dudley, May 20th Speech

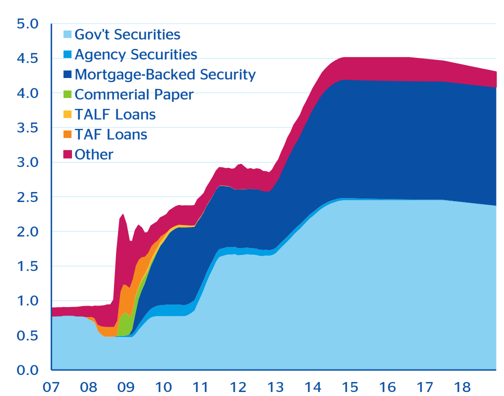
Nevertheless, we find that under the assumption that the Fed would hold both mortgage-backed securities and long-term Treasury securities to maturity, the balance sheet will still hover above $2.2tn by 2024.

Chart 2
S&P 500 Index and FRB Assets to GDP Ratio (M Avg. and %)



Source: FRB, BEA, S&P & BBVA Research

Chart 3
Federal Reserve Balance Sheet (tn)



Source: FRB & BBVA Research

Economic Indicators Ahead the FOMC Meeting

The economic indicators weigh in for the Fed to stay on track with tapering. The FOMC is expected to stay the course of gradual tapering with another $10bn reduction in the pace of asset purchases at the June 17th – 18th meeting, announcing monthly purchases of $15bn of mortgage-backed securities and $20bn of longer-term Treasury securities.

Table 1
Economic Outlook Ahead June 17th – 18th FOMC Meeting

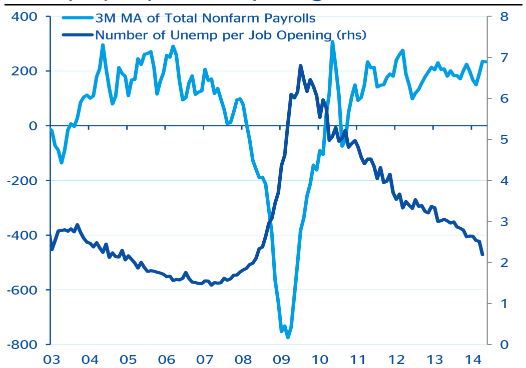
	FedSpeak	Ahead of FOMC Meetings			
Economic Indicators	Goal	Sep-12 QE3 Start	Dec-13	Mar-14	May-14
Unemployment rate	7%	8.1%	7.0%	6.7%	6.3%
3M MA Change in Nonfarm Payroll	190K	122K to 135K	193K	190	234
Number of Unemployed per Job Opening	2	3.35	2.87	2.517	2.18*
PCE Inflation (YoY)	2%	1.58%	0.74%	1.14%	1.62%*

*last data available is April 2014

Source: BLS, BEA, FRB Chicago & BBVA Research

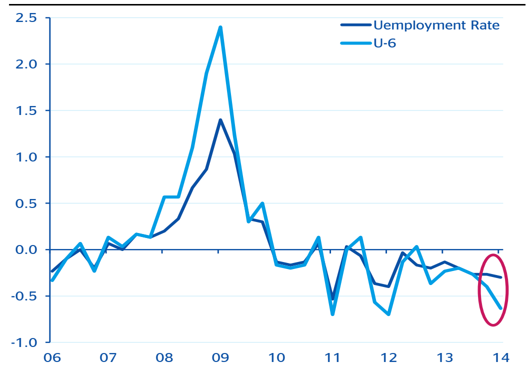
There are sound improvements across diverse labor market indicators. In addition to the sizable drop in the unemployment rate within last two months, measures of labor market health suggested by FOMC doves, including Dudley's ratio of 2 unemployed persons per job opening and Chair Yellen's U-6 measure (total unemployed plus marginally attached workers plus total employed part-time for economic reasons) reflect sustainable progress toward full employment. At the same time, inflation –measured by core PCE index- trended upward for the last two months at an annualized rate of 2.1%.

Chart 4
Total Nonfarm Payrolls and Number of Unemployed per Job Opening



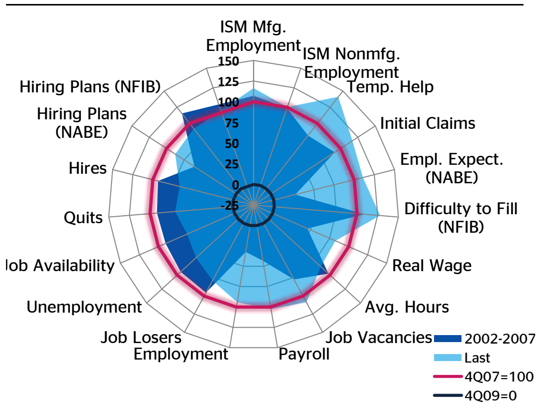
Source: BLS & BBVA Research

Chart 5
Unemployment Rate and U-6 Measure (QoQ, %)



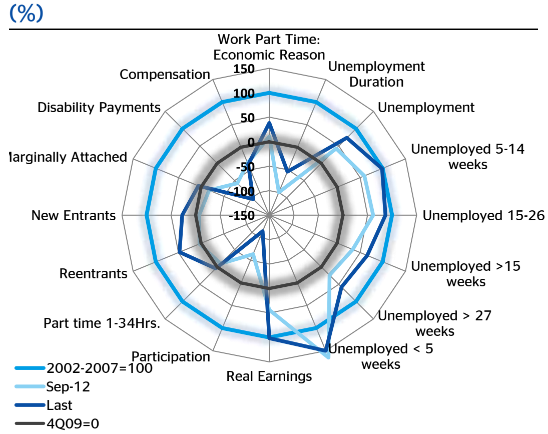
Source: BLS & BBVA Research

Chart 6
Labor Market Outlook (%)



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

Chart 7
Labor Market Utilization (%)



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

Bottom Line: Fed will Stay the Course Towards Normalization

The current course of Fed tapering is expected to stay on track with another $10bn reduction in the pace of asset purchases, announcing monthly purchases of $15bn of mortgage-backed securities and $20bn of longer-term Treasury securities. Likewise, we maintain our expectations of QE3 ending in 4Q14 and the first rate hike occurring in mid-2015. The June 17th - 18th meeting's FOMC discussion will center on the exit strategy and ways to control short-term rates after the lift-off from a near-zero policy rate while managing a roughly $4.5tn balance sheet. Communication strategy for the timing of the lift-off and the trajectory of rates after lift-off is another challenging subject to be tackled by the FOMC. Chair Yellen will have to address these issues at the post-meeting press-conference. The Committee will also publish a Summary of Economic Projections in which new incoming Committee members Fischer and Mester will have their first inputs.