Economic Analysis

Communication Challenges Ahead for the FOMC

Kim Fraser Chase

The September FOMC minutes offered a glimpse inside the decision to keep what was interpreted by markets as a "dovish" stance on unchanged forward guidance. Why did the FOMC retain the language regarding the "considerable time" between the end of QE3 and the first rate hike? According to the minutes, some participants saw it as a "risk-management" tool, suggesting that "it would be prudent to err on the side of patience while awaiting further evidence of sustained progress toward the Committee's goals." There was also cautiousness against a change in forward guidance that could be misinterpreted as a "signal of a fundamental shift" in FOMC policy stance. However, the Committee's worry regarding the risks of downside economic shocks was not domestic in nature but rather could arise abroad due to the global economic slowdown and the appreciation of the dollar, particularly against the euro, the yen and the pound sterling. Further discussions on forward guidance highlighted the eventual need of evolution in the language used as the future change in policy stance will also require a new manner to convey it. While approaches to what would be an appropriate change to forward guidance varied, the FOMC agreed that "when changes to the forward guidance become appropriate, they will likely present communication challenges, and that caution will be needed to avoid sending unintended signals about the Committee's policy outlook." So far, the FOMC has highlighted that on balance, the geopolitical conflicts, such as events in the Middle East and Ukraine, have limited the effect of what could be perceived as a "hawkish" communication on the longer end of the yield curve. Overall, the Committee has likely aimed to push back market expectations regarding the timing of the first policy rate hike aligning it with recent Fed speak of "middle of next year" (Dudley, FRB New York, October 7th). This reassures our expectation of the first federal funds rate increase occurring in mid-2015. Likewise, we expect that the Fed will continue to adjust policy plans and the overall trajectory of federal fund rate dependent on incoming data (see FedWatch for more details).

Big Shifts in August's Job Openings and Hires Rates, but in Opposite Directions

The JOLTS report for August hinted at another strong improvement for job openings, up nearly 5.0% to 4835K. This marks the largest monthly gain since April, lead primarily by the leisure and hospitality sector and education and health services. Two of the more heavily-watched sectors throughout the recovery – manufacturing and construction – did not live up to the strength seen in other areas. Manufacturing openings increased a modest 1.4%, not quite enough to make up for July's loss, while construction openings declined a massive 17.3% following an 8.6% loss in the previous month. This does not bode well for the stability of the housing recovery and its contribution to overall economic growth in the coming months. Despite this weakness, the overall job openings rate jumped to 3.4%, the highest of the recovery thus far and even surpassing the pre-crisis norm of 3.3%. Hiring, on the other hand, declined 6.0% in August to 4640K, confirming additional weakness in manufacturing and construction. The hires rate dropped from 3.6% in July to 3.3% in August, falling below the job openings rate for the first time in recorded history. So far, hiring has not caught up to the increase in job openings, and August's report points to continued structural weakness in the labor market. While we have seen faster-than-expected declines in the unemployment rate, we remain hesitant to accept that the labor market is without its flaws. Lingering issues, including the number of long-term unemployed, discouraged workers and those dropping out of the labor force, skills mismatch, and increases in part-time/temporary help relative to full-time positions (among others), remain on our radar, and we look for further discussions in upcoming FOMC meetings to shed more light on the impact on monetary policy changes.

Week Ahead

Retail Sales (September, Wednesday 8:30 ET)

Forecast: 0.1%, 0.2% Consensus: -0.1%, 0.4% Previous: 0.6%, 0.5%

Retail sales are expected to increase in September but at a slower rate than in the previous month. Weekly surveys have noted significant volatility in retail sales throughout the month as consumers transitioned from back-to-school shopping to fall weather and early Halloween promotions. At the headline level, retail sales will likely be dragged down by the auto sector as the Autodata report for September noted a sharp decline for the month that almost completely reversed the gain seen in August. Furthermore, falling gas prices will continue to weigh on the nominal retail sales figure.

Industrial Production (September, Thursday 9:15 ET)

Forecast: 0.3% Consensus: 0.4% Previous: -0.1%

The industrial production index has officially surpassed its pre-recession peak and is expected to continue along that upward trend in September. Industrial output in August declined for the first time since January, noting particular weakness in manufacturing. However, mining and utilities output reverted from negative growth in the prior months. For September, we expect that the transition to colder weather will help maintain utilities output, and the month is usually a strong one for mining. When it comes to manufacturing, we do not expect to see another decline but the latest data for the sector do not suggest a strong boost in activity for the month.

Housing Starts and Building Permits (September, Friday 8:30 ET)

Forecast: 1010K, 1025K Consensus: 1006K, 1030K Previous: 956K, 1003K

Housing starts and building permits both fell sharply in August but are expected to rebound at least partially in September. July's sharp jump in starts and permits was not long-lived, and new home construction is still very much on shaky ground. However, the gain in building permits suggests a delayed increase in housing starts, possibly in store for September as activity adjusts for August's downfall. We continue to expect some volatility on a month-to-month basis, but overall we should start to see a stronger upward trend in both starts and permits throughout the next year or so.

Consumer Sentiment (October, Friday 9:55 ET)

Forecast: 85.0 Consensus: 84.0 Previous: 84.6

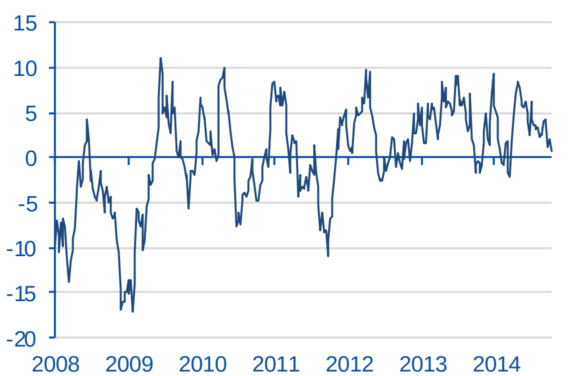
Consumer sentiment is expected to increase slightly in October, building on the consecutive gains seen throughout the past few months. Confidence in September shifted from current conditions to expectations, with the latter increasing for the first time in five months. Views on current economic conditions declined in September but should turn around again in October as early holiday sales and falling gas prices weigh favorably on consumer activity. Therefore, we do expect to see another modest monthly gain in the overall consumer sentiment index as the outlook for jobs and income gradually improve.

Market Impact

Things are starting to heat up on the economic calendar, and even this holiday-shortened week could hold more surprises in store compared to the previous few weeks. Consumer data, production, and construction for the end of 3Q make their debut this week, and we'll also see some initial signs of manufacturing for the start of 4Q. Markets will certainly be more sensitive to incoming economic news, particularly after the FOMC minutes re-emphasized the Fed's intent for data-dependent policy changes.

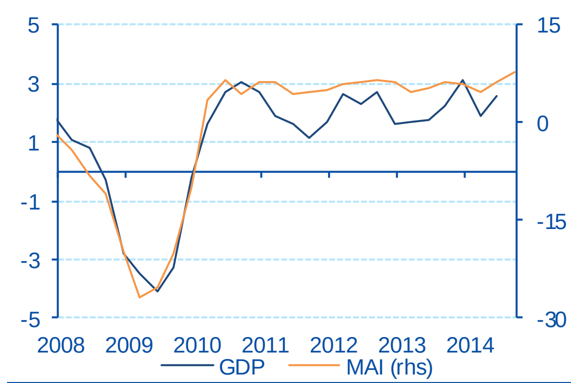
Economic Trends

Graph 3
BBVA US Weekly Activity Index (3 month % change)



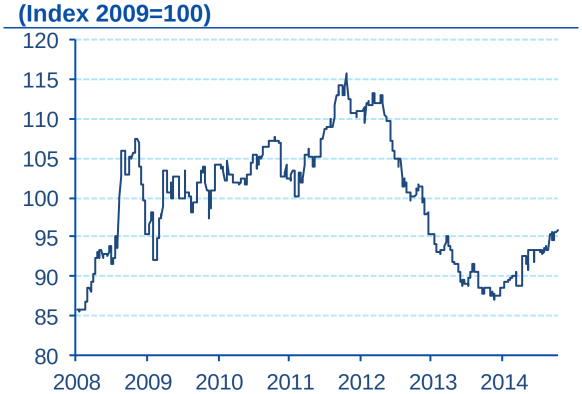
Source: BBVA Research

Graph 4
BBVA US Monthly Activity Index & Real GDP (4Q % change)



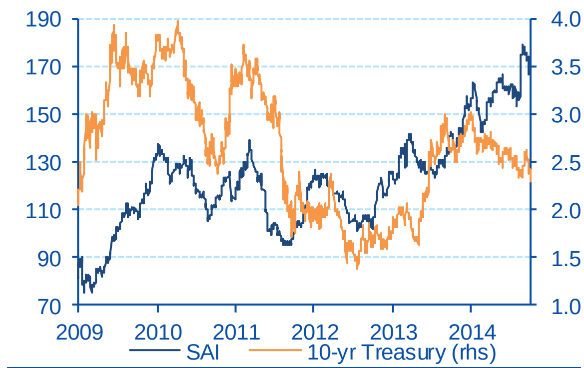
Source: BBVA Research & BEA

Graph 5
BBVA US Surprise Inflation Index (Index 2009=100)



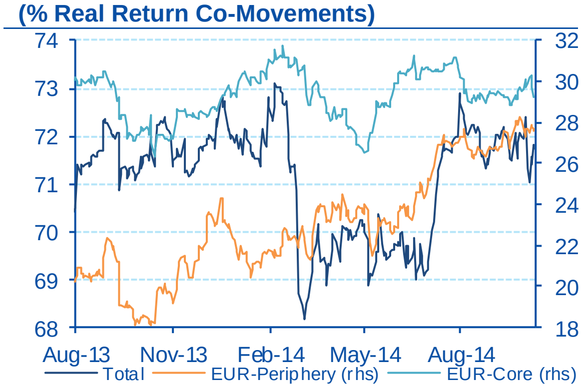
Source: BBVA Research

Graph 6
BBVA US Surprise Activity Index & 10-yr Treasury (Index 2009=100 & %)



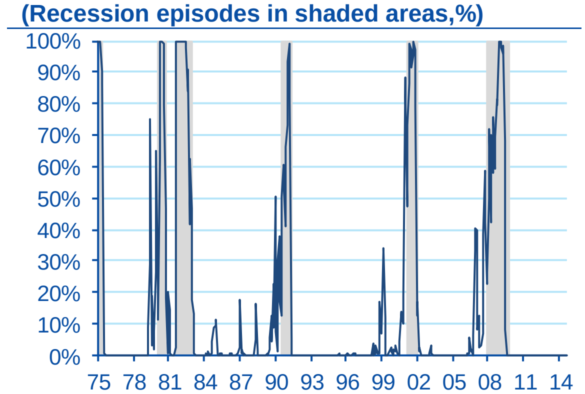
Source: Bloomberg & BBVA Research

Graph 7
Equity Spillover Impact on US (% Real Return Co-Movements)



Source: BBVA Research

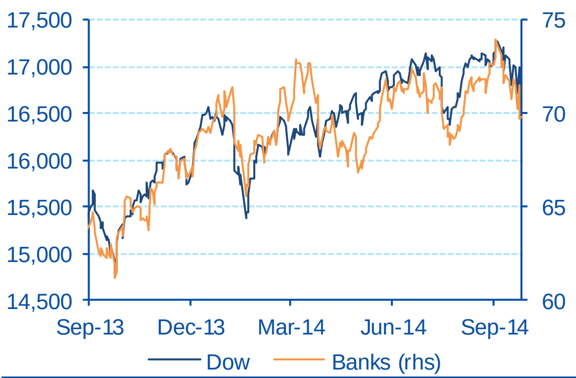
Graph 8
BBVA US Recession Probability Model (Recession episodes in shaded areas,%)



Source: BBVA Research

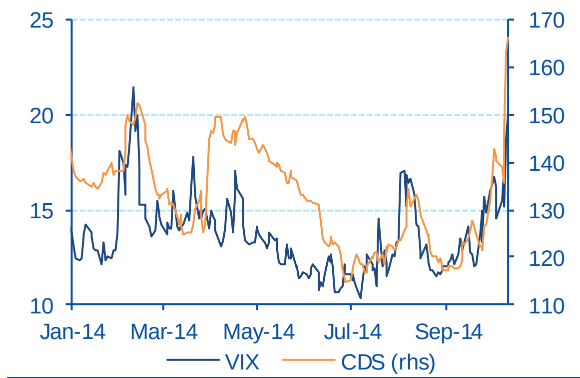
Financial Markets

Graph 9
Stocks
(Index, KBW)



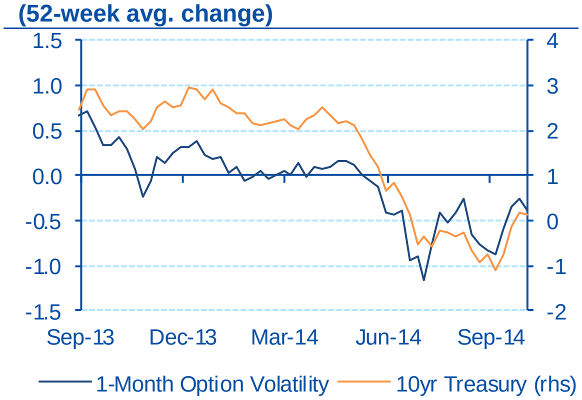
Source: Bloomberg & BBVA Research

Graph 10
Volatility & High-Volatility CDS
(Indices)



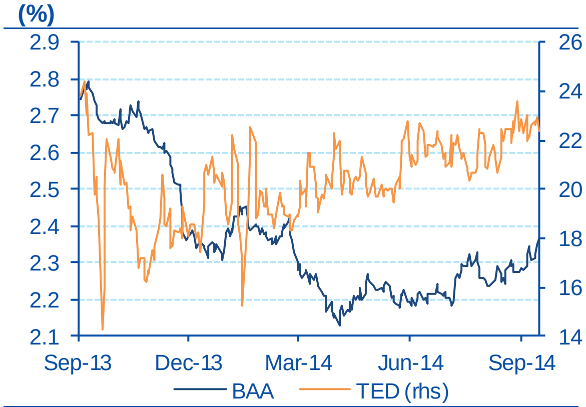
Source: Bloomberg & BBVA Research

Graph 11
Option Volatility & Real Treasury
(52-week avg. change)



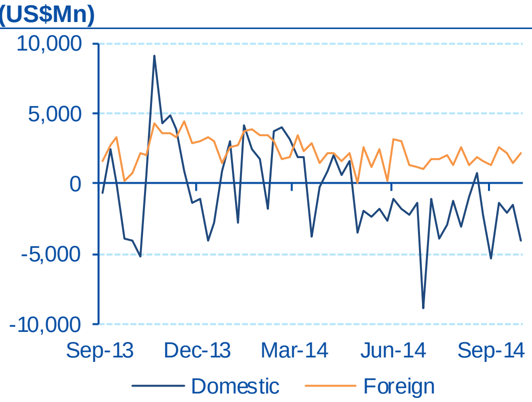
Source: Haver Analytics & BBVA Research

Graph 12
TED & BAA Spreads
(%)



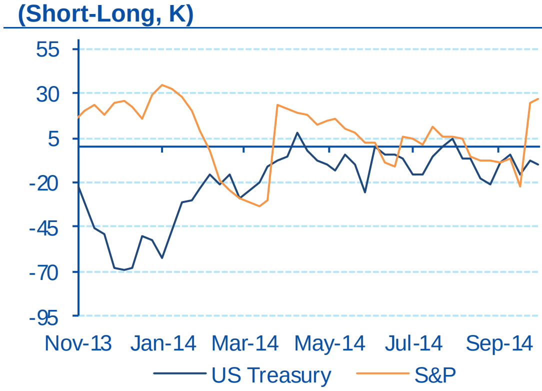
Source: Bloomberg & BBVA Research

Graph 13
Long-Term Mutual Fund Flows
(US$Mn)



Source: Haver Analytics & BBVA Research

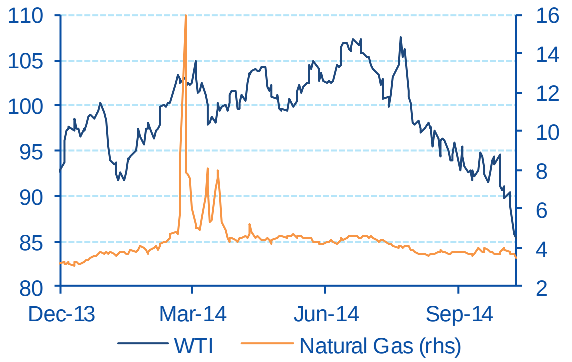
Graph 14
Total Reportable Short & Long Positions
(Short-Long, K)



Source: Haver Analytics & BBVA Research

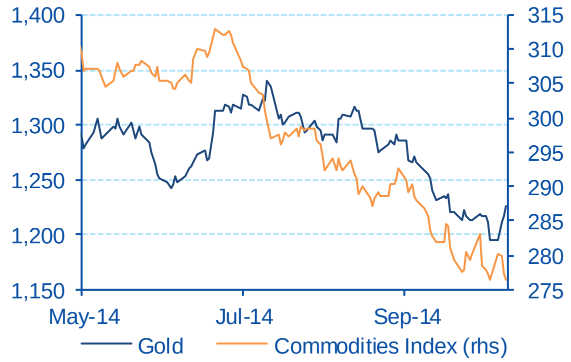
Financial Markets

Graph 15
Commodities
(Dpb & DpMMBtu)



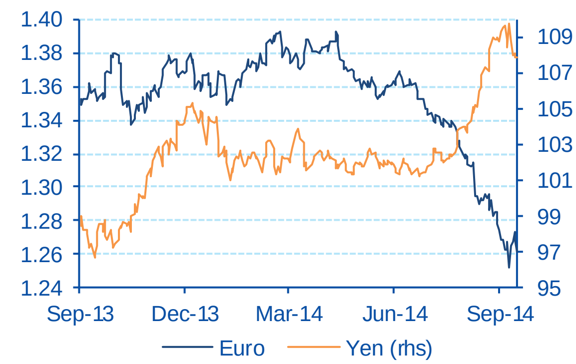
Source: Bloomberg & BBVA Research

Graph 16
Gold & Commodities
(US$ & Index)



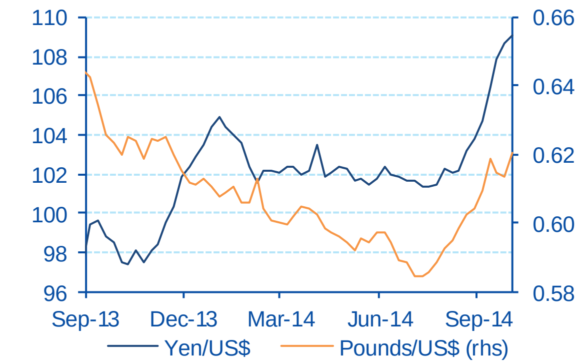
Source: Haver Analytics & BBVA Research

Graph 17
Currencies
(Dpe & Ypd)



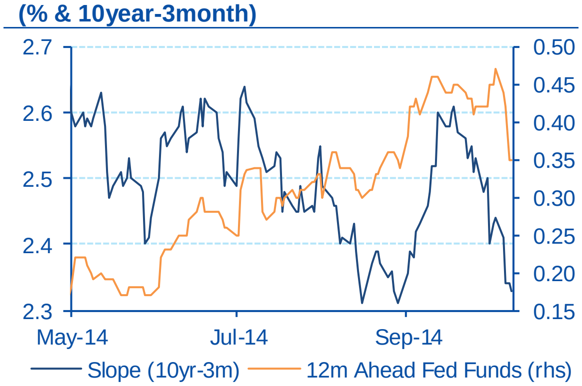
Source: Bloomberg & BBVA Research

Graph 18
6-Month Forward Exchange Rates
(Yen & Pound / US$)



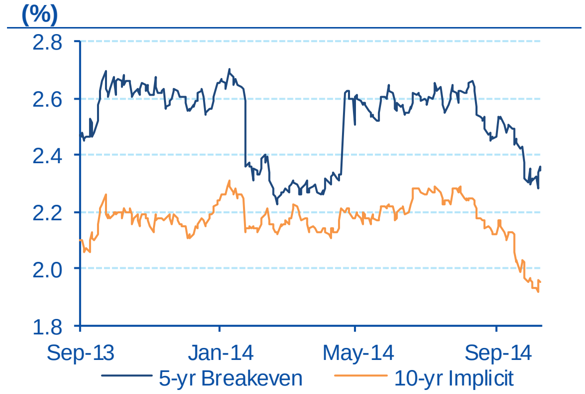
Source: Haver Analytics & BBVA Research

Graph 19
Fed Futures & Yield Curve Slope
(% & 10year-3month)



Source: Haver Analytics & BBVA Research

Graph 20
Inflation Expectations
(%)



Source: Bloomberg & BBVA Research

Interest Rates

Table 1
Key Interest Rates (%)

	Last	Week ago	4-Weeks ago	Year ago
Prime Rate	3.25	3.25	3.25	3.25
Credit Card (variable)	14.86	14.86	14.86	14.10
New Auto (36-months)	2.94	2.94	2.93	2.51
Heloc Loan 30K	4.81	4.81	4.81	5.28
5/1 ARM *	3.05	3.06	2.99	2.90
15-year Fixed Mortgage *	3.30	3.36	3.26	3.23
30-year Fixed Mortgage *	4.12	4.19	4.12	3.99
Money Market	0.42	0.42	0.40	0.41
2-year CD	0.89	0.89	0.87	0.80

*Freddie Mac National Mortgage Homeowner Commitment US
Source: Bloomberg & BBVA Research

Table 2
Key Interest Rates (%)

	Last	Week ago	4-Weeks ago	Year ago
1M Fed	0.08	0.07	0.09	0.10
3M Libor	0.23	0.24	0.23	0.24
6M Libor	0.32	0.33	0.32	0.36
12M Libor	0.57	0.58	0.55	0.63
2yr Sw ap	0.71	0.82	0.80	0.48
5yr Sw ap	1.74	1.91	1.97	1.58
10Yr Sw ap	2.44	2.59	2.75	2.86
30yr Sw ap	3.02	3.13	3.34	3.76
30day CP	0.10	0.12	0.11	0.12
60day CP	0.12	0.11	0.11	0.15
90day CP	0.13	0.13	0.13	0.16

Source: Bloomberg & BBVA Research

Quote of the Week

Stanley Fischer, Federal Reserve Board Vice Chairman
Fischer Says 'Considerable Time' is 2 Months to a Year
9 October 2014

"It looks like the markets have it right, somewhere in the middle of the year…People who are in the market should be thinking about what the Fed will be doing as the data come in but we will describe what we will do to the best of our knowledge as the data come in. If the data come in differently, we will say different things. It's not complicated."

Economic Calendar

Date	Event	Period	Forecast	Survey	Previous
14-Oct	NFIB Small Business Optimism Index	SEP	96.00	95.85	96.10
15-Oct	US Empire State Manufacturing Survey General Business Conditions SA	OCT	20.90	20.00	27.54
15-Oct	Adjusted Retail & Food Services Sales SA Total Monthly % Change	SEP	0.10	-0.10	0.60
15-Oct	Adjusted Retail Sales Less Autos and Gas Stations SA MoM Percent Change	SEP	0.20	0.35	0.50
15-Oct	US PPI Final Demand MoM SA	SEP	-0.10	0.10	0.00
15-Oct	US PPI Final Demand Less Foods and Energy MoM SA	SEP	-0.10	0.10	0.10
15-Oct	US Manufacturing & Trade Inventories Total MoM SA	AUG	0.50	0.40	0.40
16-Oct	US Initial Jobless Claims SA	OCT 11	291.00	290.00	287.00
16-Oct	US Continuing Jobless Claims SA	OCT 4	2375.00	2380.00	2381.00
16-Oct	US Industrial Production MoM 2007=100 SA	SEP	0.30	0.40	-0.10
16-Oct	US Capacity Utilization % of Total Capacity SA	SEP	79.00	79.00	78.80
16-Oct	US Industrial Production Industry Groups Manufacturing MoM SA	SEP	0.20	0.30	-0.40
16-Oct	National Association of Home Builders Market Index SA	OCT	59.00	59.00	59.00
16-Oct	Philadelphia Fed Business Outlook Survey Diffusion Index General Conditions	OCT	19.80	19.75	22.50
17-Oct	US New Privately Ow ned Housing Units Started by Structure Total SAAR	SEP	1010.00	1006.00	956.00
17-Oct	Private Housing Authorized by Bldg Permits by Type Total SAAR	SEP	1025.00	1030.00	1003.00
17-Oct	University of Michigan Survey of Consumer Confidence Sentiment	OCT P	85.00	84.00	84.60

Forecasts (Note: Revisions Pending)

	2011	2012	2013	2014	2015	2016	2017
Real GDP (% SAAR)	1.8	2.8	1.9	**2.0**	**2.5**	**2.8**	**2.8**
CPI (YoY %)	3.1	2.1	1.5	**1.9**	**2.2**	**2.3**	**2.4**
CPI Core (YoY %)	1.7	2.1	1.8	**2.0**	**2.1**	**2.3**	**2.4**
Unemployment Rate (%)	8.9	8.1	7.4	**6.3**	**5.9**	**5.8**	**5.5**
Fed Target Rate (eop, %)	0.25	0.25	0.25	**0.25**	**0.50**	**1.50**	**2.50**
10Yr Treasury (eop, % Yield)	1.98	1.72	2.90	**3.00**	**3.50**	**3.75**	**4.00**
US Dollar/ Euro (eop)	1.31	1.31	1.37	**1.25**	**1.22**	**1.25**	**1.28**