Central Banks

FOMC Statement: October 28th – 29th

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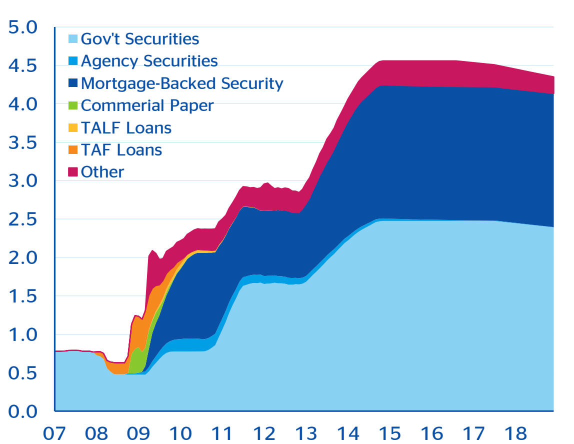
Fed Ends QE3 as Expected while Maintaining Reinvestment Policy

- **FOMC concluded QE3 but kept reinvestment policy unchanged, maintaining accommodative conditions with balance sheet holdings steady at the current $4.56tn**
- **Improved labor market outlook signals Fed's measured movement towards policy normalization**
- **Low energy prices identified as a driving force behind the recent decline in inflation expectations**
- **Kocherlakota dissented on dovish sentiment to keep QE3 at its current pace of $15bn**

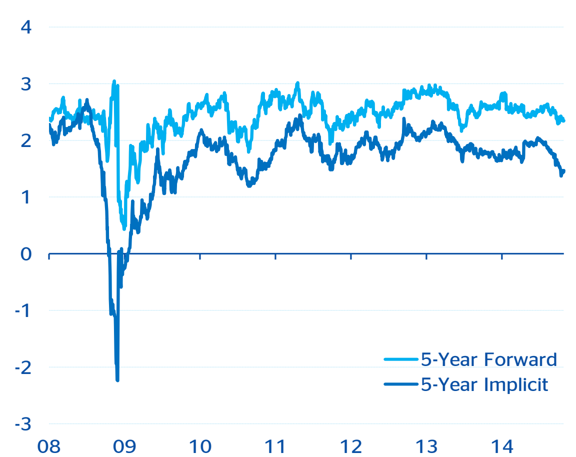
The FOMC moved one step closer towards policy normalization with the announcement to "conclude its asset purchase program." The "substantial improvement in the outlook for the labor market" was named as the main decisive factor behind ending QE3. In line with the strategy previously set by Fed expectations, the Committee maintained its reinvestment policy to keep FOMC holdings of longer-term Treasury securities and mortgage-backed securities at the existing high levels. Thus, the Fed reassured financial markets that the current accommodative conditions will continue. Another reassurance from the Committee, in order to keep financial markets at bay, was the decision not to introduce any changes to forward guidance alongside with ending QE3. The forward guidance language remained unchanged, still indicating that the anticipation of the near zero federal funds rate will remain "for a considerable time following the end of its asset purchase program this month."

Chart 1
Federal Reserve Balance Sheet (tn)



Source: FRB & BBVA Research

Chart 2
Inflation Expectations (%)

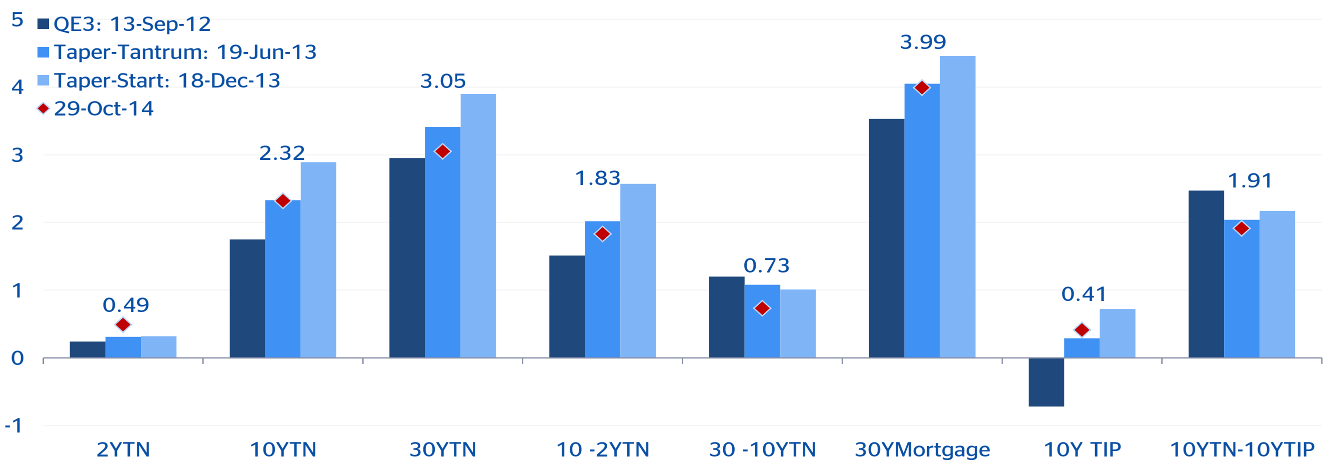


Source: FRB & BBVA Research

Another hawkish move by the Fed was the change in language with regard to the labor market. The FOMC switched its language from “significant underutilization of labor resources” to “gradually diminishing” underutilization of these resources. However, the Fed remains cautious regarding its language on the inflation outlook. The statement highlighted the decline in energy prices and identified this as the major factor behind low inflation in the near-term economic outlook.

Market reactions to the statement were surprisingly calm. The S&P500 and Dow Jones both bounced around slightly when the statement was initially released but ended the day down a minor 14 and 18 basis points, respectively. The 10-year Treasury note jumped to a high of 2.35% in the afternoon but closed at 2.32%, up slightly from 2.30% yesterday. These modest movements suggest that the Fed’s communication strategy has been more successful in setting market expectations for monetary policy and limiting financial market disruption.

Chart 3
FOMC Announcements Impact on Interest Rates (%)



Source: FRB & BBVA Research

Narayana Kocherlakota (FRB Minneapolis) was the sole dissenter to the FOMC action, objecting to the end of the asset purchase program. He advocated keeping the pace of asset purchases at the $15bn monthly pace and tying the current range of federal funds rate to the “one-to-two-year ahead inflation outlook.” Kocherlakota held his dovish stance and will likely support these policies until the inflation expectation returns to 2 percent.

Table 1
Economic Outlook

Economic Indicators	Goal	Sep-12 QE3 Start	Dec-13	May-14	Oct-14
Longer Run Unemployment rate	5.2% to 5.5%	8.1%	7.0%	6.3%	5.9%
3M MA Change in Nonfarm Payroll	200K	122K to 135K	193K	234	224
Number of Unemployed per Job Opening	2	3.35	2.87	2.14	1.98*
PCE Inflation (YoY)	2%	1.58%	0.74%	1.65%	1.46%*

*last data available is Aug 2014

Source: FRB, BLS, BEA, FRB Chicago & BBVA Research

Bottom Line: Fed Progresses in Measured Steps towards Normalization

The FOMC actions remain in line with our expectations, with the official end to QE3 signaling an important step towards policy normalization. At the same time, the data-dependency factor remains vital to future monetary policy action, with the Fed stressing that a faster-than-expected improvement in the economic outlook could result in "increases in the target range for the federal funds rate are likely to occur sooner than currently anticipated." On the contrary, if the economy progresses slower than the FOMC expects, "increases in the target range are likely to occur later than currently anticipated." Given the heightened focus on low inflation, we expect that the FOMC will be willing to hold off on the first rate hike until mid-2015, though the probability for an early rate hike will increase if the downward pressure on inflation fades by the end of this year, in parallel with sustainable improvements in the labor market.