Central Banks

FOMC Statement: July 28-29th

Kim Chase

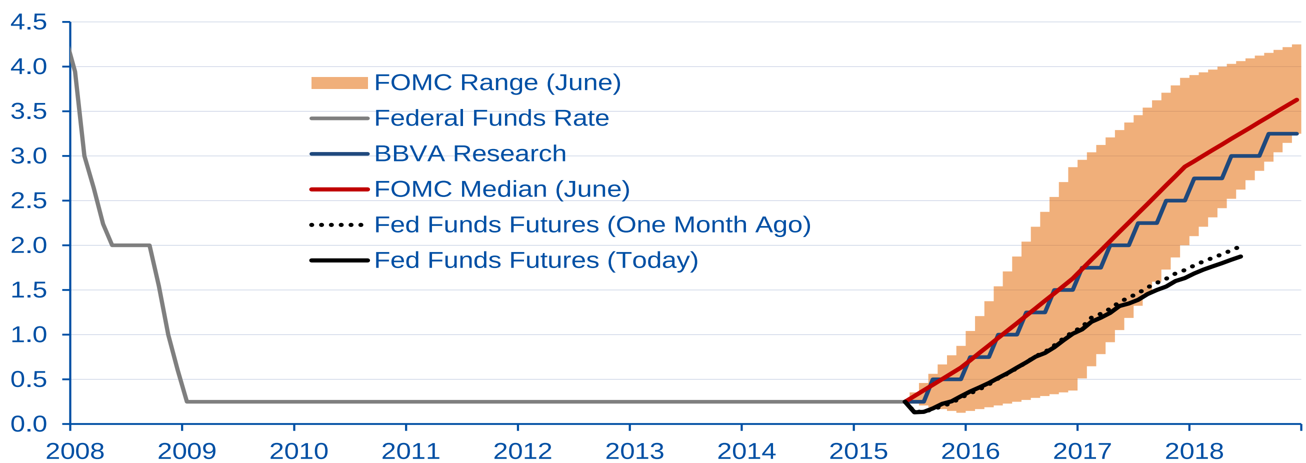
No Rate Hike in July, but FOMC Getting Close to Appropriate Time for Liftoff

- **As expected, the FOMC did not increase rates in July and made no specific mention to a potential increase in September**
- **Changes to the statement were minimal and mostly reflected a slightly more optimistic view on the labor market**
- **Our expectations remain for the first rate hike in September, closing out 2015 at 0.5%**

July's FOMC statement has come and gone with no federal funds rate hike, bringing us one step closer to the highly anticipated September meeting. While there was no specific mention alluding to a September rate hike, the statement portrayed a slightly more optimistic stance compared to the previous meeting.

Compared to June, the Committee made only minor revisions to the statement, most of which involved their assessment of economic data. The statement emphasized ongoing improvements in the labor market, highlighting the view that "underutilization of labor resources has diminished since early this year." Comments on inflation were unchanged, with the FOMC continuing to acknowledge low prices and stable inflation expectations. The Committee did remove language in reference to stabilizing energy prices, adjusting for the fact that oil prices have fallen slightly in recent weeks. It is possible that the FOMC is trying to downplay their commitment to inflation for the time being, allowing labor market improvements to take over as the primary reason for increasing rates in the near future. Once the first rate hike has occurred, the FOMC will have some breathing room in order to increase rates at a path more consistent with their outlook for inflation.

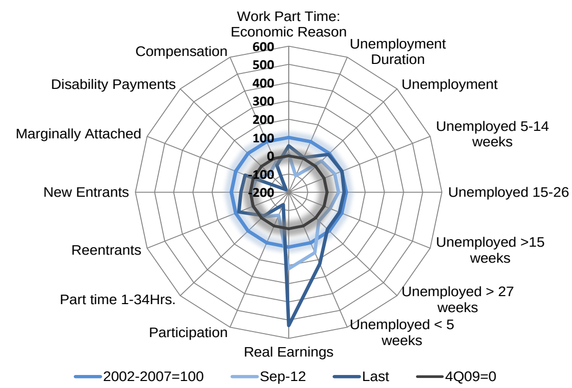
Chart 1
Federal Funds Rate Futures and Projections (%)



Source: FRB & BBVA Research

Unfortunately, there was no specific mention in the statement alluding to when the rate hike will occur. FOMC members held steady in their data dependent strategy, noting that a rate hike would be appropriate once they have seen “some further improvement in the labor market”. This gives them some room to play with incoming economic data as long as “some” of the indicators hint at improving conditions. The FOMC also maintained the desire to feel “reasonably confident that inflation will move back to its 2 perfect objective over the medium term.”

Chart 2
Labor Utilization



Source: Haver Analytics & BBVA Research

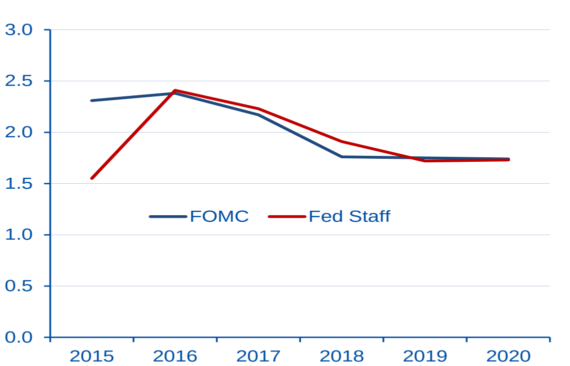
Chart 3
Fed’s Economic Outlook

	Unemployment Rate	3MMA Change in Nonfarm Payrolls	Number of Unemployed per Job Opening	PCE Core Inflation (YoY)	Average Hourly Earnings (YoY)
Goal	5.2% - 5.5%	200K	2.00	2.00%	+2.50%
QE3 Start (Sept-12)	7.8%	157K	3.38	1.66%	1.44%
Dec-13	6.7%	198K	2.64	1.34%	2.16%
QE3 End (Oct-14)	5.7%	228K	1.85	1.48%	2.27%
May/June 2015	5.3%	221K	1.62	1.24%	1.94%

Source: FRB, BLS, BEA, & BBVA Research

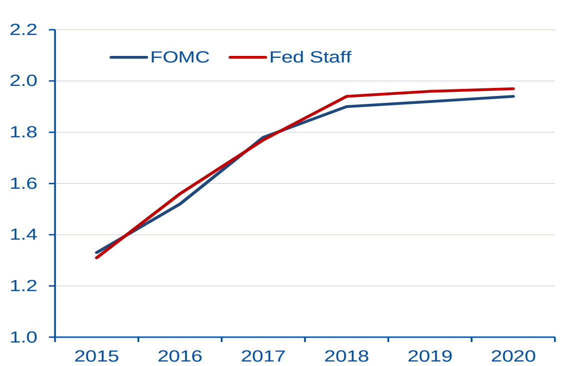
These relatively optimistic FOMC views build on expectations for ongoing improvements in economic activity, supporting a September rate hike as long as conditions do not veer off track. However, it is worth mentioning the discrepancies between the FOMC projections and the Federal Reserve staff forecasts that were released inadvertently on July 24th. The staff forecasts, which FOMC members had in advance of the June FOMC meeting, depicted a more pessimistic outlook – GDP growth below 2.0% in 2015 and inflation not reaching the Fed’s target within the next five years. If the FOMC were to assume these forecasts instead of what were officially released in the Summary of Economic Projections, a rate hike in September (or even this year) would seem less likely to occur. Even with these differences, the FOMC and staff projections for the federal funds rate were the same, as were the forecasts for other interest rates, the unemployment rate, and the GDP output gap.

Chart 4
FOMC vs Fed Staff Forecasts, GDP (4Q % Change)



Source: FRB & BBVA Research

Chart 5
FOMC vs Fed Staff Forecasts, Core PCE Inflation (4Q % Change)



Source: FRB & BBVA Research

Bottom Line: September Rate Hike Still in the Cards

The FOMC is close to achieving economic conditions under their data-dependent strategy. Important data releases throughout the next few months, including employment and inflation reports for July and August, will be closely monitored. Assuming that economic activity does not weaken, we maintain our expectations for the first rate hike in September. There is still a risk that global pressures could further delay the FOMC's plans if conditions deteriorate and volatility increases in the intermeeting period. However, in delaying liftoff the Fed risks losing credibility. At this point it seems that they are ready to get over the first rate hike and deal with a more gradual pace of normalization thereafter.