

Central Banks

FOMC Statement: September 16th – 17th

Kim Chase

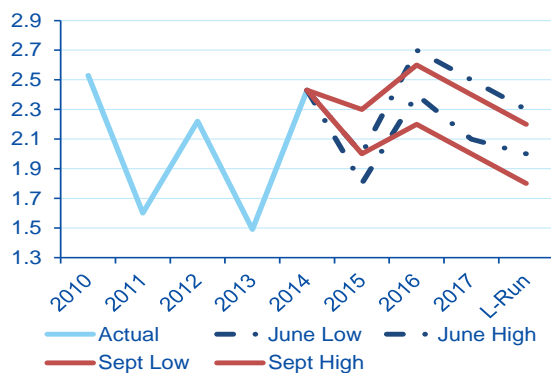
Dovish Views Dominate as FOMC Holds Back on Rate Hike

- **Low inflation and global financial market volatility to blame for another FOMC delay**
- **A few members pushed out expectations for liftoff – now 3 votes in 2016 and 1 in 2017**
- **Focus shifts to December for the first hike as long as data evolve in line with Fed’s outlook**

September’s FOMC statement showed the Committee’s true dovish colors, forcing us to wait again for the first rate hike since June 29, 2006. Details in the statement do not reveal any new reasoning behind the delayed rate hike, but instead reemphasize the need to see “some further improvement in the labor market” and to be “reasonably confident that inflation will move back to its 2 percent target over the medium term.” Immediately before the meeting today, the implied probability of a September rate hike had dropped to just 18% (from 30% a few days ago and a high of 60% in early June). In an effort to avoid any surprises, the delay aligns the Fed with market expectations set prior to the meeting.

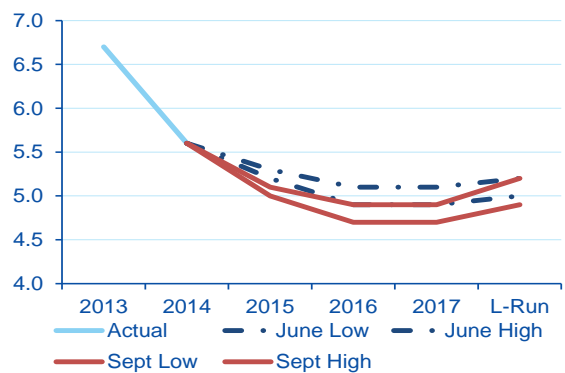
There were certainly a variety of arguments in favor of a rate hike at this time, including the ongoing improvement in the labor market. Most notably, the unemployment rate fell to 5.1% in August, the lowest since May 2008, settling in at the Fed’s long-run equilibrium forecast. Furthermore, there has been a significant decline in long-term unemployment (27+ weeks), dropping below the level of short-term unemployed (less than 5 weeks) for the first time since before the crisis. Although wage growth remains subdued, the ongoing rise in job availability and working hours suggests that businesses, in an effort to attract skilled workers, are nearly ready to increase wages. One FOMC participant – Jeffrey Lacker (FRB Richmond), the lone dissenter – would have preferred to start the normalization process now in order to leave more time to assess the impact. However, the doves were dominant, and lingering concerns on low inflation and global financial market volatility won out in the debate.

Chart 1
Change in Real GDP, 4Q % Change (Central Tendency)



Source: Federal Reserve & BBVA Research

Chart 2
Unemployment Rate, 4Q % (Central Tendency)



Source: Federal Reserve & BBVA Research

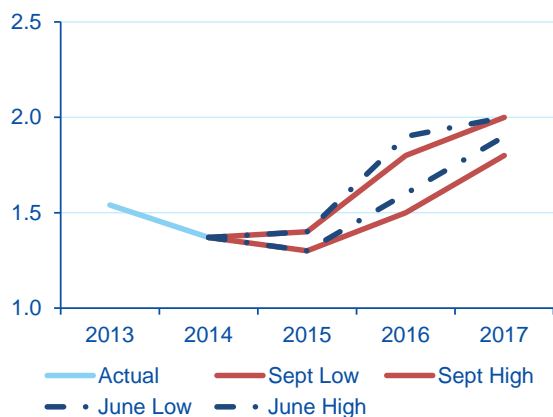
The statement noted that “recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term.” Clearly, the latest spillover from China’s market crumble has spooked some among the Committee. In addition, FOMC members stressed the risk to inflation from lower import prices, considering the appreciation of the USD and the possibility that higher rates could intensify the dollar’s strength.

The dovish undertones were also evident in the updated Summary of Economic Projections, though the changes compared to June’s meeting were not large. GDP growth projections increased slightly for the short-term but shifted lower after 2016. The long-run central tendency for GDP (1.8-2.2%) portrays a much less encouraging outlook compared to prior projections (2.0-2.3%). This suggests that the Fed has accepted the post-crisis low-growth environment as the “new normal”, with declining productivity and labor force participation weighing on potential growth.

Not surprisingly, the FOMC revised their unemployment rate projections to reflect the actual data seen throughout the past few months. Based on these updated forecasts, the Fed expects the unemployment rate to continue falling at a similar pace as we have seen in the past year. Again, this is reflecting some of the structural changes that we have seen in the labor market compared to the pre-crisis period, including the rapid decline in the participation rate. In her press conference, Yellen noted some lingering concerns regarding weakness in cyclical participation and that they will continue to monitor these developments closely.

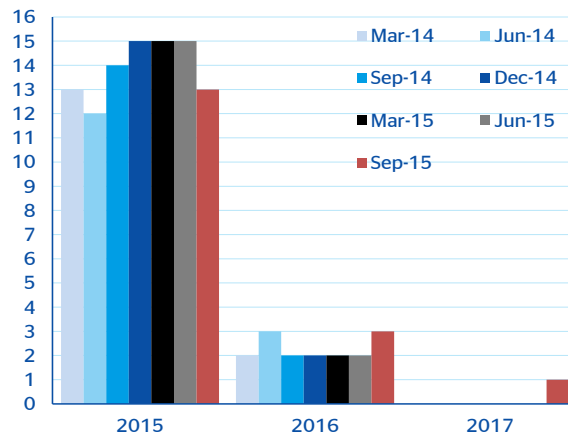
Although inflation appeared to be a major reason for delaying the rate hike, the revised projections for core PCE prices are not much lower than June’s estimates. Short-term forecasts were unchanged, and the long-run rates were brought down only slightly (from 1.9-2.0% to 1.8-2.0%). Still, the FOMC does not see core PCE inflation hitting their target of 2.0% until 2018, which is in line with our expectations.

Chart 3
Core PCE Inflation, 4Q % Change
(Central Tendency)



Source: Federal Reserve & BBVA Research

Chart 4
Appropriate Timing of Policy Firming
(Number of Participants)



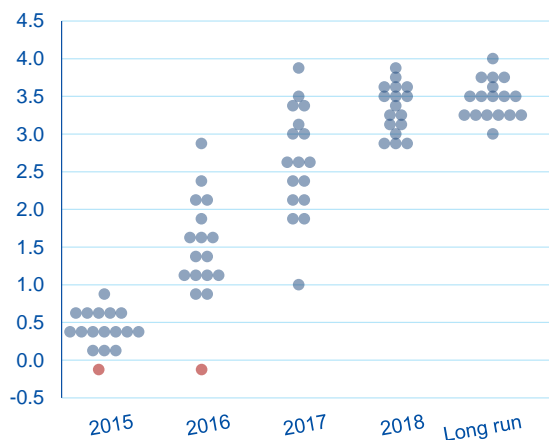
Source: Federal Reserve & BBVA Research

One of the biggest adjustments since June was a shift in the FOMC participants’ assessments of the appropriate timing for monetary policy. Two members moved their expectations for the first rate hike from 2015 to 2016, and an additional shifted into 2017. This extreme dove is Narayana Kocherlakota (FRB Minneapolis) who has argued for some time that the economy is nowhere near ready to handle higher rates. He plans to step down once his

term ends in February 2016, and we can assume that his replacement will share at least some of his dovish views, though maybe not to this extreme.

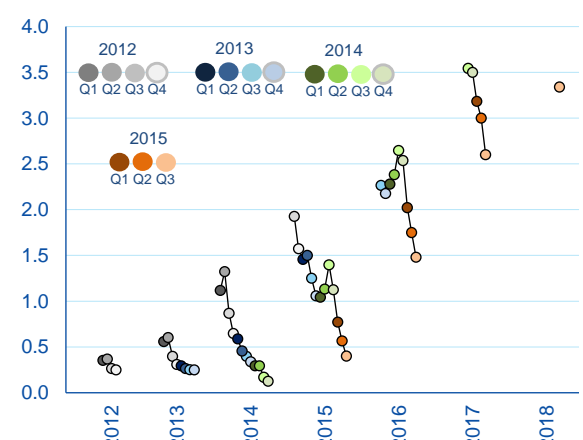
September's "dot plot" is different in the sense that we have negative expectations for the federal funds rate in 2015 and 2016, the first time we have seen this in the Fed's official expectations. Median projections have declined since June, especially with only two meetings left for a hike in 2015. In the long-run, the median expected rate dropped from 3.63% in June to 3.5% in September, suggesting an even more gradual pace of rate hikes (one less 25bp increase) compared to the previous meeting. It is also interesting to note that the Fed has consistently revised down their projections throughout the past few years – on average, they have rarely been surprised to the upside when it comes to the timing of the first rate hike.

Chart 5
Target Federal Funds Rate Forecast, September
(Year-end %)



Source: Federal Reserve & BBVA Research

Chart 6
Average Federal Funds Rate Projections
(2012-present, %)

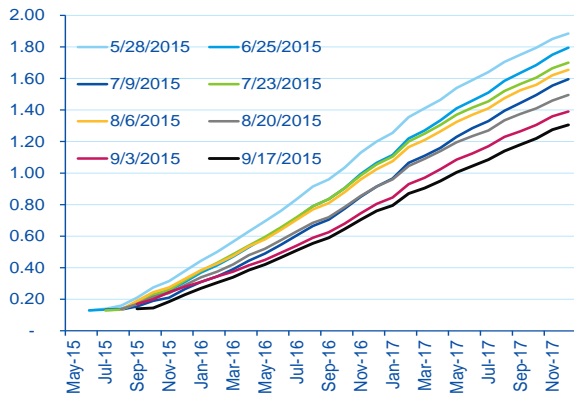


Source: Federal Reserve & BBVA Research

Yellen's press conference didn't clarify much from the statement. She continues to emphasize that the Committee is looking at a "wide range of data" in order to assess whether the economy is making progress towards their objectives. In light of the latest global market volatility, Yellen and her colleagues were more inclined to wait for additional proof that the economy could withstand higher rates. There was no specific mention of when the rate hike will come, but she did reiterate that every meeting is "live" and that they will continue this meeting-by-meeting approach to monetary policy.

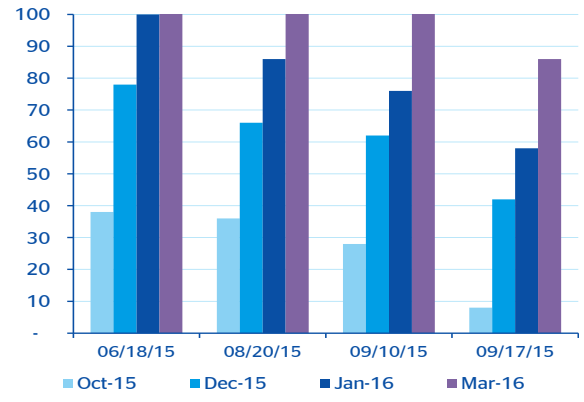
Market reactions were mostly neutral, with equity markets spiking immediately after the announcement but closing the day just below opening levels. The 10-year Treasury yield showed the most movement, down from 2.29% at the start of the day to 2.19% at close. Most notably, federal funds futures continue to flatten, dragging down the implied probabilities for when markets think the first rate hike will actually occur. The probability of a December rate hike has now dropped below 50% due to today's extremely dovish undertones. However, we do expect that communication in the next few months will shift attention back towards the end-of-year goal for the first rate hike, as long as economic data evolve in line with the Fed's expectations.

Chart 7
Federal Funds Rate Futures (%)



Source: Bloomberg & BBVA Research

Chart 8
Federal Funds Rate Futures Implied Probabilities (First 25bp, %)

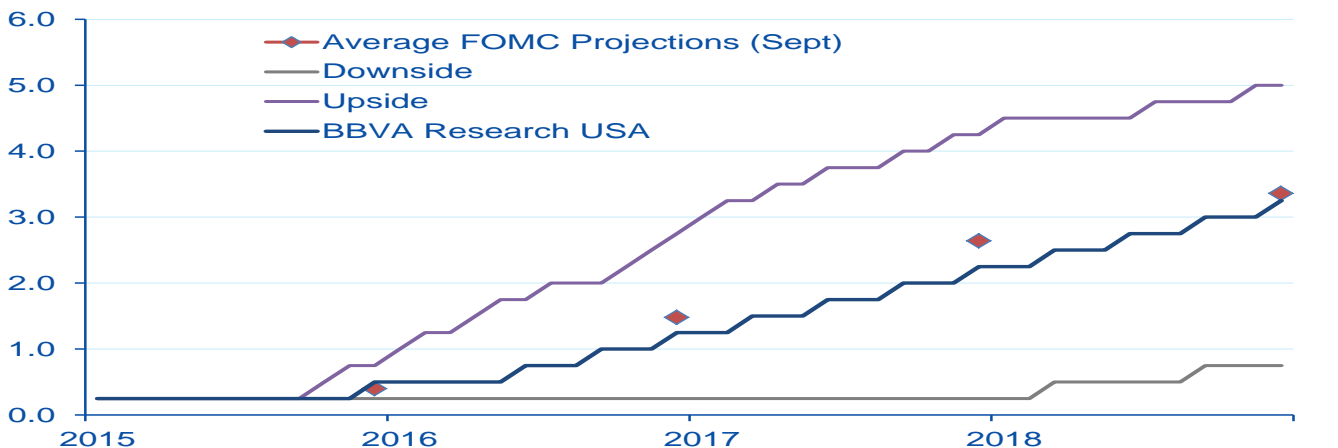


Source: FRB & BBVA Research

Bottom Line: Focus Turns to December for the First Rate Hike

The Fed's decision to delay the first rate hike has shifted our expectations to December. Although there is another FOMC meeting October 27-28th, there is no press conference or updated release of projections associated with this date. If Yellen and her colleagues are committed to keeping the surprises to a minimum, they will avoid announcing the rate hike at this meeting. Furthermore, economic data are unlikely to change much between now and the end of October. Therefore, we expect that they will wait until December to gather as much information as possible. The minutes from today's meeting will give us a better understanding of what specific requirements the Fed is looking for in incoming economic data. For now, we can assume that inflation needs to start picking up a bit more before they move forward with the rate hike. In addition, stronger vibes from the global economy would certainly help push the Fed towards liftoff, particularly as it relates to their concerns over the USD appreciation.

Chart 9
Federal Funds Rate Forecasts (%)



Source: FRB & BBVA Research

DISCLAIMER

This document was prepared by Banco Bilbao Vizcaya Argentaria's (BBVA) BBVA Research U.S. on behalf of itself and its affiliated companies (each BBVA Group Company) for distribution in the United States and the rest of the world and is provided for information purposes only. Within the US, BBVA operates primarily through its subsidiary Compass Bank. The information, opinions, estimates and forecasts contained herein refer to the specific date and are subject to changes without notice due to market fluctuations. The information, opinions, estimates and forecasts contained in this document have been gathered or obtained from public sources, believed to be correct by the Company concerning their accuracy, completeness, and/or correctness. This document is not an offer to sell or a solicitation to acquire or dispose of an interest in securities.