Fed Watch
US

June 19, 2013
Economic Analysis

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FOMC Statement: June 18-19th

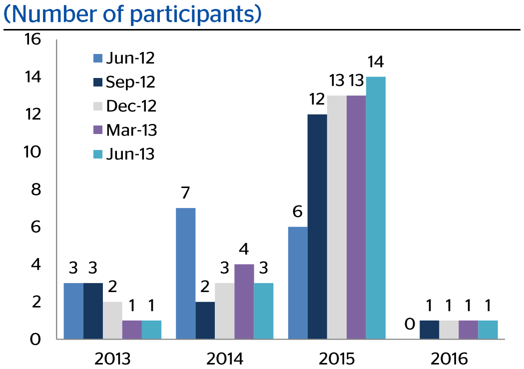
More Definitive Expectations for the Future of QE3

- **Meeting statement mostly unchanged, with the FOMC maintaining its current pace of asset purchases**
- **Market react as Bernanke reveals more details on tapering QE3 and its expected end in 1H14**
- **FOMC reemphasizes exit strategy principles but with one major difference: no sales of MBS during normalization, except for residual holdings**
- **Economic projections more optimistic, although the timeline for Fed funds rate hike remains the same**

Today's FOMC statement did not reveal many changes at face value, but instead drove various underlying implications for markets. The official statement was in line with our expectations for maintaining the current pace of $85bn per month in asset purchases (Ahead of June 18-19). The committee announced that they agreed to continue purchasing $40bn per month in mortgage-back-securities (MBS) and $45bn in longer-term Treasury securities, as well as reinvesting principle payments into MBS and rolling over maturing Treasury securities at auction. Chairman Bernanke's press conference was much more informative.

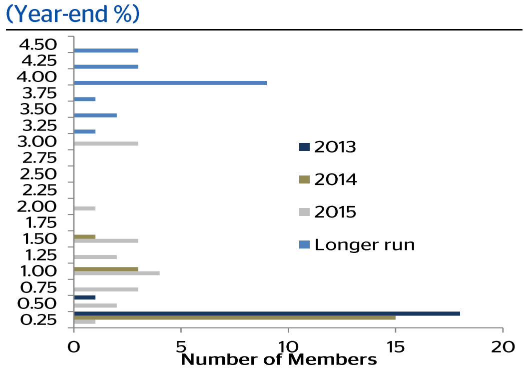
While the statement did not reflect any immediate changes to the QE3 timeline, Bernanke's comments hinted at a definitive timeline for tapering, more details on policy normalization, and added caution for the timing of the first fed funds rate hike. The recent spike in interest rates was also addressed, although Bernanke made it clear that the Fed could only partially explain these movements. Ultimately, there were mixed responses in the market from the statement as well as the press conference. Equity markets dropped somewhat by end of day while the 10-year Treasury yield jumped to the highest level seen since before QE2 began. This seems to be slightly inconsistent with what the FOMC is striving for in regards to boosting equity prices and maintaining downward pressure on long-term rates. Bernanke himself was puzzled as to what may be driving these movements. Two factors may be at play: QE3's influence on long-term rates has weakened and/or the Fed may be more confident in the economic recovery so that they no longer see the need to control long-term rates.

Chart 1
Appropriate Timing of Policy Firming (Number of participants)



Source: Federal Reserve & BBVA Research

Chart 2
Target Federal Funds Rate Forecast (Year-end %)



Source: Federal Reserve & BBVA Research

Bernanke's press conference statement gave away details on dialing down and the eventual end to QE3. In his comments he divulged a more certain timeline for slowing asset purchases that will begin later this year, closing the door on any expectations for no tapering until 2014. Furthermore, Bernanke noted that the Fed "would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear." This helps to clarify the length of the tapering process, which looks like a more extensive undertaking than implicitly discounted by market participants before the meeting. Additionally, he introduced a new "threshold" for the unemployment rate tied to the end of QE3: "when asset purchases ultimately come to an end, the unemployment rate would likely be in the vicinity of 7 percent." This timeline for the end of QE3 is the consensus among FOMC members.

On the other hand, there was no indication from the meeting statement or press conference of a change to the timing of the first expected fed funds rate hike. While the committee did confirm their 6.5% unemployment and 2.5% inflation thresholds, Bernanke left the door open for possible further review, though the only considered change would be a downward revision to the unemployment rate target. Ultimately, he made an attempt to emphasize the thresholds as simple guidance rather than a trigger, suggesting that the Fed may choose to keep rates low for some time after reaching 6.5% unemployment.

In the Summary of Economic Projections (SEP) released with the statement today, one additional FOMC member shifted his projection for the appropriate timing of policy firming from 2014 to 2015. While we did see a more optimistic unemployment rate forecast, this tells the story that Bernanke wanted to make very clear: it may take some time (possibly even a few quarters) after we reach 6.5% unemployment for the Fed to feel comfortable enough to increase rates. Other changes to the SEP suggest a slightly more optimistic outlook compared to the last official review in March. GDP expectations were revised down slightly for 2013 and 2015 but upwards for 2014. This is reflected in the core inflation forecasts as well, which were revised down drastically for 2013 to 1.2-1.3% from 1.5-1.6%. Core PCE expectations were also a bit lower for 2014 and 2015. On the other hand, recent data encouraged FOMC members to adjust their unemployment forecasts. Most importantly, the committee now sees potential for 6.5% unemployment in 2014 instead of the previous expectation for 2015.

As we expected, the FOMC discussed the exit strategy when the time comes appropriate for balance sheet normalization. While there were no new details in the statement, Bernanke confirmed in his press conference that the "broad principles" outlined in June 2011 still apply; however, given the change in balance sheet composition since then, it is likely that the Fed will hold on to MBS during the normalization process, as we suggested in our Fedwatch (May 22nd). Furthermore, it is important to note that in the Fed's plan, normalization will come after the first fed funds rate hike. Since the execution of the policy normalization is far away, we should not expect a clear outline for the "Exit Strategy Principles" but rather continued discussions in upcoming FOMC meetings.

Addressing the minor changes in the meeting statement, there was a mixed bag of hawkish and dovish adjustments. On the one hand, today's statement noted that downside risks to economic growth and the labor market have "diminished since the fall" (referring to the start of QE3), a much more optimistic sentiment compared to the previous statements. On the other hand, there was more reassertion regarding the lower than expected inflation rate, as the statement replaced the view on inflation running "somewhat below" with the more affirmative "below the Committee's longer-term objective." According to the Committee's view, the softer than expected inflation is "partly reflecting transitory influences," which likely refers to softer demand for commodities from Europe and China. While this is a dovish addition to the statement, it was likely disappointing for some participants. Bullard (Federal Reserve Bank of St. Louis), who voted against the action for the first time, argued that the statement "should signal more strongly" the committee's readiness to counteract deflation, citing a lack of "willingness to defend its inflation goal in light of recent low inflation readings." At the other end of the spectrum, also voting against the action was Ester George (Federal Reserve Bank of Kansas City), who remains concerned that increased monetary policy accommodation poses risks for economic and financial imbalances as well as increased inflation expectations.

Bottom Line: Slow and Steady Wins the Race

With today's information from Bernanke's press conference and the FOMC statement, we remain convinced that the Fed will take a slow and steady approach to backing down from their highly accommodative monetary policy stance. We continue to expect that the FOMC will begin to dial down asset purchases in late 3Q13, ultimately concluding the program in 1H14. While this is a more certain timeline for QE3 compared to prior statement information, the Fed's actions are clearly data-driven. Therefore, the adjustment to QE3, whether it be dialing up or dialing down asset purchases, is subject to change if upcoming economic reports veer off course.

Table 1
Federal Reserve Forecast Comparison: June 19th FOMC Statement and Press Conference (Central Tendency)

	June 2013 FOMC Projections					March 2013 FOMC Projections			
	2013	2014	2015	Long-term		2013	2014	2015	Long-term
GDP, 4Q yoy % change					**GDP, 4Q yoy % change**				
Low	2.3	3.0	2.9	2.3	Low	2.3	2.9	2.9	2.3
High	2.6	3.5	3.6	2.5	High	2.8	3.4	3.7	2.5
Unemployment rate, 4Q %					**Unemployment rate, 4Q %**				
Low	7.2	6.5	5.8	5.2	Low	7.3	6.7	6.0	5.2
High	7.3	6.8	6.2	6.0	High	7.5	7.0	6.5	6.0
Core PCE, 4Q yoy % change					**Core PCE, 4Q yoy % change**				
Low	1.2	1.5	1.7		Low	1.5	1.7	1.8	
High	1.3	1.8	2.0		High	1.6	2.0	2.1	

Source: Federal Reserve & BBVA Research