U.S.

Fed Watch

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Economic Analysis

Hakan Danış
hakan.danis@bbvacompass.com

Kristin Lomicka
kristin.lomicka@bbvacompass.com

Jeffrey Owen Herzog
jeff.herzog@bbvacompass.com

FOMC Statement: June 22-23

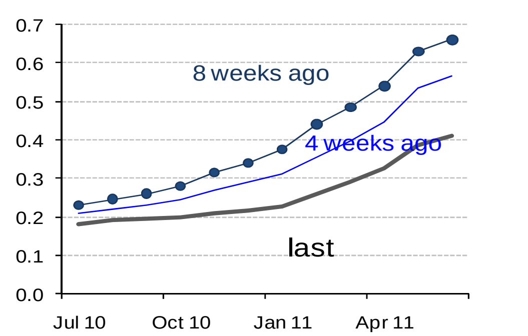
Modest growth, low inflation, but with risks

- **Contagion from global financial uncertainty a risk factor for growth**
- **Inflation forecast remains low and positive, but with elevated discussion of deflation**
- **Unemployment to occupy a central issue in policymaker's calculations**

Economic conditions still warrant exceptionally low rates for an extended period of time

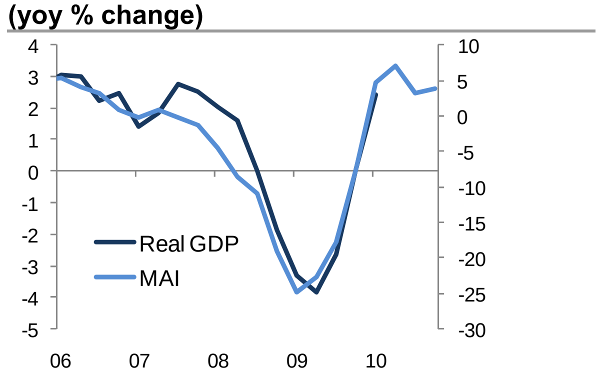
According to the minutes from the June 22-23, 2010 FOMC meeting, participants believe that recent economic data are consistent with their expectations of a moderate recovery. In conjunction with this meeting, participants released updated economic forecasts, which were revised down slightly. The downward revisions were due in part to emerging risks to global financial markets from European Union sovereign debt problems. Both residential and commercial real estate continue to pose risks as financing remains tight and post-tax credit demand for housing will be low. The labor market will remain at the top of the watch list as participants expect the pace of hiring to remain low for some time. Furthermore, members believe the unemployment rate could remain well above its long-run sustainable level for several years, suggesting a possible shift in the natural rate of unemployment, which partly guides policy decisions. One significantly positive note is that members believe private demand has strengthened to the point that the inventory adjustment and fiscal stimulus are no longer the only drivers of economic growth. On the household side, consumer spending is expected to continue to post moderate gains as income growth and improved consumer confidence offset the hindering effects of lower stock prices and housing wealth. The committee agrees that inflation remains subdued, but there was notable discussion regarding the risks. Some members saw downside risks, a few focused on the possibility of deflation, while others thought prices would not fall further due to well anchored inflation expectations. On the business side, credit market financing is improving for more-creditworthy business borrowers. This trend positively impacted spending on equipment and software, but the pace of this spending will slow as the replacement of old equipment postponed from the recession gradually declines.

Chart 1
Fed Funds Expectations (Futures Contract End, %)



Source: BBVA Research and Bloomberg

Chart 2
Real GDP vs BBVA US Monthly Activity Index (yoy % change)



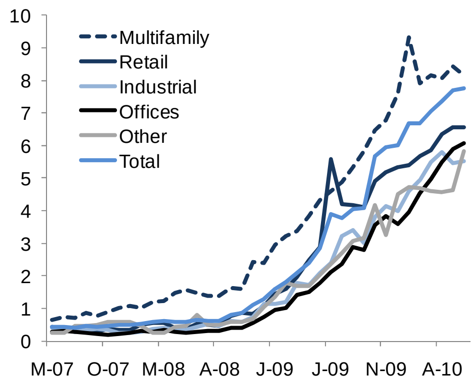
Source: BBVA Research and BEA

We maintain our baseline scenario for a first rate hike in 1Q11

Today's minutes release suggests FOMC members are concerned about persistent labor market weakness. Members still envisage a moderately-growing economy and only lightly revised their GDP forecast, but they see greater risk factors than their previous projections. One such example is contagion risk from Europe's sovereign debt issues. Members maintained their low but positive inflation forecast, but they are increasingly discussing deflationary scenarios. In total, we expect the Fed to continue a low interest rate policy for an extended period of time, which is consistent with our baseline scenario of a first rate hike in 1Q11.

Chart 3

CMBS 30+ Delinquencies by Property Type

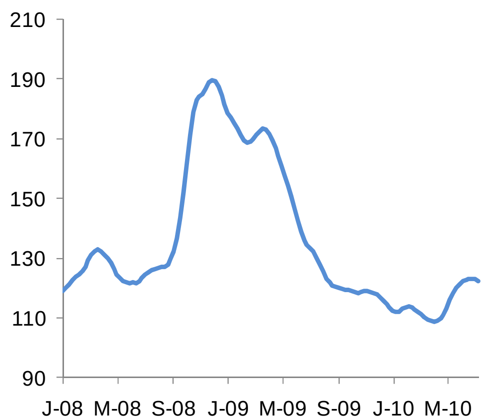


Source: Bloomberg

The Federal Reserve noted that strains in the Commercial Real Estate sector remain a risk factor for the banking system and structures investment. Financing for Commercial Mortgage-Backed Securities (CMBS) face tight credit conditions, elevated spreads and rising delinquency rates.

Chart 4

BBVA US Weekly Risk Aversion Index, 1990=100



Source: BBVA Research. Corporate spread refers to BAA.

The Federal Reserve also highlighted the increased risk aversion since their previous meeting that occurred as a result of the sovereign debt crisis in Greece. Our dynamic factor model index of risk aversion encompassing the S&P 500 implied option volatility, corporate spread and TED spread suggests risk aversion remains high, but appears to have eased somewhat in recent days.

Chart 5

Federal Reserve Forecast Comparison, June 22-23 FOMC Minutes

June 2010 FOMC Projections			
	2010	2011	2012
GDP, yoy % change			
High	3.8	4.5	5.0
Low	2.9	2.9	2.8
Unemployment rate, %			
High	9.9	8.9	7.9
Low	9.0	7.6	6.8
Core PCE, yoy % change			
High	1.5	2.4	2.2
Low	0.7	0.6	0.4

April 2010 FOMC Projections			
	2010	2011	2012
GDP, yoy % change			
High	4.0	4.6	5.0
Low	2.7	3.0	2.8
Unemployment rate, %			
High	9.7	8.7	7.7
Low	8.6	7.2	6.4
Core PCE, yoy % change			
High	1.6	2.4	2.2
Low	0.7	0.6	0.6

Source: Federal Reserve

BBVA Research

Chief Economist for US and Mexico
Jorge Sicilia
J.Sicilia@bbva.bancomer.com

Chief Economist for US
Nathaniel Karp
Nathaniel.karp@bbvacompass.com

Ignacio San Martin
Ignacio.SanMartin@bbvacompass.com

Jeffrey Owen Herzog
Jeff.Herzog@bbvacompass.com

Marcial Nava
Marcial.Nava@bbvacompass.com

Hakan Danış
Hakan.Danis@bbvacompass.com

Jason Frederick
Jason.Frederick@bbvacompass.com

Kristin Lomicka
Kristin.Lomicka@bbvacompass.com

Contact details

BBVA Research
5 Riverway Drive
Houston, Texas 77056
ResearchUSA@bbvacompass.com

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