Fed Watch

US

21 September 2011
Economic Analysis

US
Hakan Danış
hakan.danis@bbvacompass.com

Jeffrey Owen Herzog
jeff.herzog@bbvacompass.com

Nathaniel Karp
nathaniel.karp@bbvacompass.com

FOMC Statement: Sept 20-21

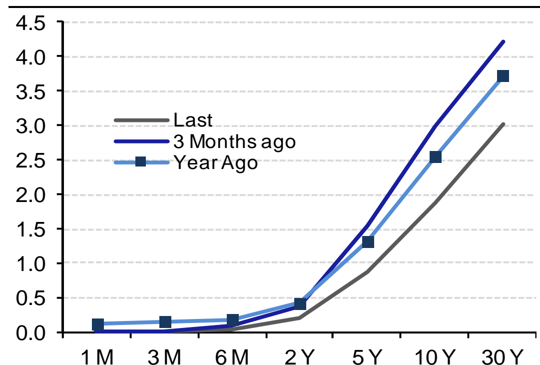
Operation Drop-Kick Begins

- **Fed to move $400bn from short-term to long-term Treasuries by 2012Q2**
- **Principal reinvestment shifted to agency securities from Treasuries**
- **Program is aimed squarely at reversing a depressed housing sector**

Three dissents continue as Fed unveils new program for stimulus

The statement by the Federal Reserve acknowledged slow economic growth and significant downside risks to the outlook. At the same time, inflation is expected to be at or below the Fed's implicit inflation target. While equipment and software continues to expand, the housing sector remains depressed. Given these trends, the Federal Reserve decided to lengthen the average maturity of its balance sheet by selling shorter-term Treasury holdings and purchasing longer-term maturity holdings, as we expected. The Fed plans to purchase by June 2012 around $400bn in Treasury securities. In addition to these efforts, the Fed will also reinvest principal from maturing securities into agency mortgages instead of its previous policy of reinvestment into Treasuries. As such, the size of the balance sheet will not change, but the duration will be higher and the level of mortgage securities will no longer shrink. The Fed may be targeting specifically the housing market's woes by lowering mortgage and other long-term interest rate to the point where activity finally resumes in residential investment. In other words, the Fed is applying a drop-kick to the housing market. One problem with this strategy is that the Fed cannot completely control the 30y mortgage rate. Outside of affecting the level based on the 10 or the 30y Treasury (upon which they maintain better control), the spread on the 30yr mortgage is dependent on some measures of risk and cost of securitization. Home prices and expectations of households play a role. However, the Fed could be acknowledging this issue by implementing its shift of reinvestment to agency securities, which should marginally improve the environment for securitization. Banks may continue to be reluctant to hold mortgage loans on their balance sheets due to the flattening of the yield curve. The next move for the Fed will be to follow the economic indicators in housing, employment and inflation expectations to determine if this drop-kick to the housing sector is working. If growth prospects start to really fall apart the Fed would consider more action, which would involve an expansion of the balance sheet. At the very least, they will need to take 6 months considering the program is slated to last 9 months. However, if a significant external shock occurs (for example, renewed European debt issues) then action will be needed sooner.

Chart 1
Yield Curve (%)



Source: Haver Analytics & BBVA Research

Table 1
Maturity Extension Program Composition

Nominal Coupon Securities by Maturity Range	
6 - 8 Years	32%
8 - 10 Years	32%
10 - 20 Years	4%
20 - 30 Years	29%
TIPS 6 - 30 Years	3%

Source: Federal Reserve Bank of New York

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.