RESEARCH

Fed Watch

US

April 9, 2014
Economic Analysis

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FOMC Minutes: March 18-19th

Discussion Downplays Change in Fed Funds Expectations

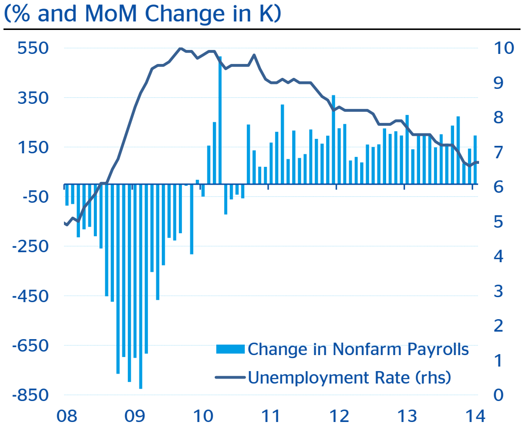
- **Yellen's "six months" comment not discussed in meeting**
- **Change to forward guidance supported by majority of FOMC**
- **We expect QE3 to end in 4Q14 and the first rate increase in mid-2015**

The release of the minutes from the March FOMC meeting brought calm to the markets, projecting a more dovish stance on the timing and the path of the policy rate increase. This contrasted with the strong hawkish reaction in the equity and bond markets after March 19th statement, triggered by the uneasiness regarding forward guidance modifications, steeper FOMC projections on the timing and trajectory of a policy rate increase, and most importantly, Yellen's likely unintentional hawkish comment implying an earlier rate hike than market expectations.

Conversely, unlike Yellen's press conference, the minutes did not reveal any discussion regarding a calendar date for policy firming. This confirms our expectation that the "six months" comment was merely a personal opinion and not something that was discussed seriously during the meeting. Most of the participants felt strongly about communicating that even after the first federal funds rate (FFR) increase, "economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."

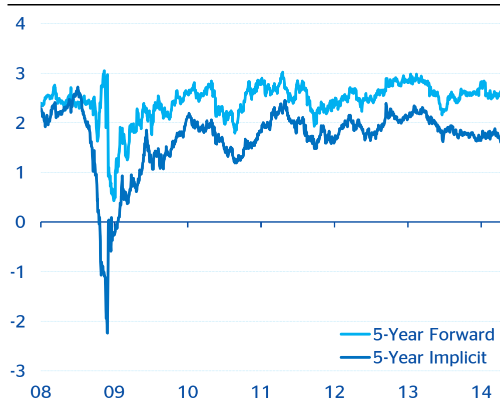
An important driver behind the hawkish reaction to March's statement was the fact that the median expectations of the FFR projections increased and the dispersion for each year slightly narrowed. However, those statistical shifts were likely driven by the lower than usual number of voting members – with only 9 FOMC voting members in March 2014 vs. 10 in December 2013- and not by an all-encompassing hawkish shift. In fact, the minutes stated that "some" participants expressed concern that these projections "could be misconstrued as indicating a move by the Committee to a less accommodative reaction function." Likewise, "several participants noted that the increase in the median projection overstated the shift in the projections."

Chart 1
Unemployment Rate and Nonfarm Payrolls (% and MoM Change in K)



Source: BLS & BBVA Research

Chart 2
Inflation Expectations (%)



Source: FRB & BBVA Research

The last two meetings' minutes revealed that the FOMC is shifting its focus towards crafting an effective communication strategy for policy tightening. The March statement carried a strong move to redefine forward guidance and anchor market expectations for the exit strategy. Also important to note is that the minutes revealed an additional FOMC video-conference held early in the month ahead of March 18th-19th meeting to discuss the removal of the 6.5% unemployment rate threshold from the forward guidance, as all the participants agreed that the unemployment threshold "was becoming outdated." As a result, "most participants" agreed in the official meeting to replace the numeric threshold with "qualitative descriptions of the factors that would influence the Committee's decision to begin raising the federal funds rate." Additionally, "most participants" during the video conference held a stance that "quantitative thresholds, triggers, or floors should not be a part of future statement language." Interestingly, the minutes reveal that the discussion on the trajectory of the balance sheet and reinvestments of current holdings is likely to become more relevant in upcoming meetings.

Despite the soft economic data in 1Q14, the tapering path appears to be set on auto-pilot. In line with our expectations, all but two FOMC members found it appropriate to continue the reduction of the pace of QE3 purchases "in measured steps and to conclude purchases in the second half of this year." The outlying two participants preferred a more rapid reduction in the pace of purchases with an earlier end to QE3. Overall, the Committee continued to expect improvement in economic growth and the labor market in line with the FOMC's Summary of Economic Projections, with "nearly balanced" risks to the outlook. Equally, the low and consistently below 2% PCE inflation would not diverge the FOMC from the tapering path, since a "large majority" of the Committee members anticipated headline inflation to run "slightly below" the 2% goal in 2016. Nevertheless, "all participants" expected that the stable inflation expectations and strengthening economic activity would drive a gradual rise in both headline and core inflation rates over next two years.

Bottom Line

Overall, the FOMC meeting minutes confirmed our expectations for Fed policy in the coming years. The discussion revealed majority support for ongoing asset purchase reductions in "measured steps", consistent with our projections for an end to QE3 in 4Q14. The meeting minutes also downplayed the upward shift in fed funds expectations, confirming that the market reaction was premature. As such, we maintain our expectation for the first FFR increase in 3Q15, with bias towards an earlier rate hike.

The March meeting minutes also highlighted a strong shift in the form of communicating forward guidance, as the majority of current FOMC members overwhelmingly preferred the change from quantitative thresholds to the qualitative language. While FOMC members realize the urge and importance of effective communication of the path and the trajectory of future FFR increases, they are still in the process of crafting new methods to anchor expectations for the exit strategy. Thus, we expect the FOMC to introduce further modifications to the forward guidance throughout the normalization process.