RESEARCH

Fed Watch

US

May 21, 2014
Economic Analysis

US

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FOMC Minutes: April 29th-30th

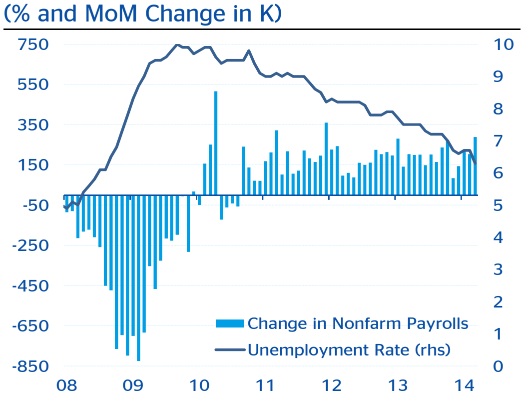
Timely Communication Set at the Core of Successful Exit Strategy

- **FOMC discusses approaches to policy normalization and tools available to control short-term rates with $4.25tn balance sheet on hand**
- **Affective forward guidance on the future path of policy rate is believed to serve a keystone to policy normalization**
- **Risks to financial stability perceived low, although long-term yields continue to trend downward**
- **Committee remains optimistic on this year's growth**

The release of the minutes from the April FOMC meeting unveiled lengthy discussions on topics related to Fed's policy normalization and what the Committee called "prudent planning." Careful to highlight that the discussion on Fed's exit strategy "did not imply that normalization would necessarily begin sometime soon," the Committee members plan to keep this conversation open and revisit it each subsequent meeting. At the same time, FOMC's main concern is to set the market expectation on the right path with timely and clear communication regarding its approaches to policy normalization stating that communication should start "well before the first steps in normalizing policy become appropriate," and "enhance the clarity and credibility of monetary policy."

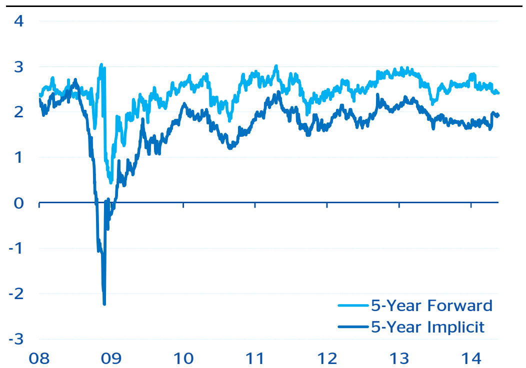
Faced with challenge of choosing a reliable set of tools that will serve well for raising short-term interest rates and controlling those rates once they have been raised, the meeting participants' opinions differed on the combinations of policy tools. In the policy environment of $4.25tn balance sheet, the list of policy tools currently available to the Fed, in addition to the interest rate paid on excess reserve balances, are fixed-rate overnight reverse repurchase (ON RRP) operations, term reverse repurchase agreements, and the Term Deposit Facility (TDF). Control over short-term interest rates, Fed balance sheet, remittances to the Treasury, functioning of the federal funds market and the financial stability are the front-liners for the FOMC in deciding on the appropriate combination of 'new' tools for future.

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



Source: BLS & BBVA Research

Chart 2
Inflation Expectations (%)



Source: FRB & BBVA Research

After positive reactions to to the tapering and the forward guidance changes in the March FOMC meeting, a number of Committee members emphasized the importance of clearly communicating the timing and path of the policy rate hike. Additionally, a few meeting participants believed that clarifying the Fed's reaction function is equally important given that economic conditions may diverge from the committee's forecasts. In theory, if the FOMC is forced to steepen the trajectory of the Fed Funds rate, communicating an ad hoc rule would soften market participant's reaction to such an unexpected increase.

Another matter that number of participants felt strongly about was the communication on Fed's policy of rolling over maturing Treasury securities at auction and reinvesting principal payments on all agency debt and agency mortgage-backed securities in agency mortgage-backed securities. Those issues were addressed in Dudley's (FRB New York) speech yesterday.

The FOMC's overall assessment of financial stability, bank capitalization and leverage suggest that the committee perceives risks to the financial sector as balanced. As would be expected with economic improvement and greater economic confidence, flows to nonfinancial non-corporate business were evaluated as strong but not excessive, with easing standards being reported by C&I and CRE loan officers. Further, the committee highlighted that leverage lending was "stretched" and credit spreads tight, but still below pre-crisis levels and thus in line with economic fundamentals. Equities, while down over the month, were deemed more consistent with fundamentals, given the pullback in small cap stocks, delay of various tech IPOs and a rebalancing balancing between the tech sector. Notwithstanding uncertainties regarding how short-term rates will respond to communication and execution of the re-normalization of a "very large balance sheet", the communication clearly reflects that Fed's holistic approach of preparing markets for the inevitable normalization.

The flattening of the yield curve was addressed in minutes, which highlighted the increase in short- and medium-term rates and the downward trend in long-term rates. Fed staff cited portfolio reallocation by large institutional investors, the trading strategies pursued by some investors, and safe-haven flows as factors that contributed to the decline in long-term yields decline.

On balance, the committee remained optimistic about economic growth, as minutes referred to the weak first quarter economic indicators as a "pause." The economic projections for long-term outlook were upbeat. Nevertheless, the Fed staff viewed the risks to the real GDP forecasts were tilted a "little to downside." Yet, a number of Committee members presume that the labor slack is higher than it is captured by the unemployment rate alone. Meanwhile, the minutes state that "the Committee did not, at present, face a tradeoff between its employment and inflation objectives, and an expansion of aggregate demand would result in further progress relative to both objectives."

Bottom Line

Overall, the Fed continues to make gradual progress towards its dual mandate. Downside risks to inflation are abating but once the transitory factors unwind it is still likely that the Fed will undershoot its inflation goal in near-term. The perception of sizeable labor market slack, uncertainty over the effectiveness of managing short-term interest rates with beta tools, and the fact that the minutes reemphasized that economic conditions may warrant keeping short-term rates low for longer than normal suggests the Fed will remain cautious of tightening too soon. Thus, our expectations for future path of the fed funds rate are unchanged and that first rate increase will occur in mid-2015.