24 January 2012

Flash Comment

FOMC preview: Historical change in communication

- **When Fed announces rates and presents new projections on Wednesday, it will mark a historical day in Fed communication. For the first time Fed will provide projections for the Fed funds rate based on the individual members' forecast.**
- **We expect Fed to forecast the first hike at the end of 2013, which is slightly earlier than the market currently projects. We thus see upside risk to bond yields in response to the statement and press conference. USD could get a lift short term but given that the market is still very long USD, the reaction will probably be muted.**
- **FOMC is set to become more dovish as three hawks and one dove will be replaced with more centrist members.**

FOMC announcements 25 Jan

18:30: Release of Fed statement

20:00: Fed projections + press conference

Source: Bloomberg

Fed projections in November 2011

%, mid-point of estimates	2011	2012	2013	Longer run
GDP (q4/q4)	1,7	2,7	3,3	2,6
Unemployment (q4)	9,1	8,6	8,0	5,6
PCE inflation (q4/q4)	2,8	1,7	1,8	1,85
Core PCE inflation (q4/q4)	1,9	1,8	1,7	

Source: *Federal reserve*

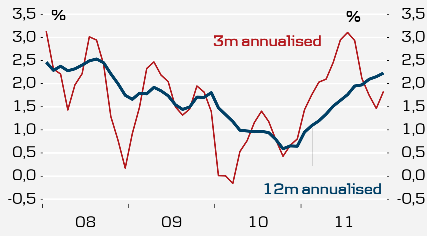
Fed funds projection expected to point to hike in end-2013

Fed's changed communication policy was outlined in the minutes to the previous meeting on page 9 – see *link*. In the Summary of Economic Projections (SEP) Fed will now add the range of members' projections of the timing of the first hike and Q4 forecasts for the Fed funds rates in the following two years. It is not clear whether information about the first hike will be provided in the FOMC statement, but we believe it will replace the current wording about policy expected to be exceptionally low until at least mid-2013.

We expect the projection to point to the first hike at the end of 2013. This is a bit earlier than the market prices at the moment, as Fed funds futures price the first hike in mid-2014. Hence we would expect a slight rise in yields on the back of the statement.

The projection will be presented with a distribution of the timing of the first hike and a chart in which all members' projections for Q4 in the forecast years are depicted - see *template for interest rate projections* released last Friday on Fed's web page.

Core inflation levelling off – but still on the high side



Source: Reuters EcoWin

Employment firming, housing better

The main economic news since the meeting in December has been:

- Continued improvement in housing with home sales, building permits and NAHB housing index pointing to rising activity in the past months.
- Employment has gained some traction and the unemployment rate has declined faster than expected. Jobless claims have also been robust lately pointing to continued recovery in the beginning of 2012.
- ISM manufacturing has continued to climb higher. ISM service more mixed.
- Equity markets have rallied, being up almost 10% since the previous Fed meeting on 13 December 2011.
- Headline inflation heading lower. Core inflation has been a bit mixed with the core PCE deflation being low, whereas the core CPI measure has been a little high recently.

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The statement

The main change in the statement is likely to be the phrase about when the Fed funds rate is expected to be changed. Fed may very well introduce an outline of the members' projection of the first hike to signal the most likely timing of a policy change.

Otherwise we expect Fed to strike a slightly more positive tone on the economy, although still cautious. Fed may - as something new - point to improvement in the housing market, but is expected to keep a cautious tone.

In the forward-looking second paragraph on the economy we do not expect any big changes. FOMC will likely still expect a "*moderate pace of economic growth over coming quarters and consequently that the unemployment rate will decline only gradually*". Fed is also likely to still "*anticipate that inflation will settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate*".

As something new FOMC could choose to highlight which levels it sees as being in line with its dual mandate – which would likely be the projections shown under "longer run" projections. These are currently 1.9% for PCE inflation and 5.6% for unemployment.

Policy outlook and market impact

We do not expect Fed to embark on QE3 as the economy is improving and we do not believe there will be consensus for further policy easing. We expect the first hike by the end of 2013. As the market does not price the first hike until mid-2014 we see scope for slightly higher yields and some strengthening of the dollar. The pace of tightening projected is likely to be very slow though, and this should temper the rise in yields. USD could get a short-term lift but since the market is still very long USD we expect the reaction to be muted and short-lived.

A slightly more dovish composition of FOMC in 2012

In 2012 the voting rights will change. The three hawks, Plosser, Fisher and Kocherlakota, will become non-voters as well as the main dove, Evans (who voted for further easing in December). Williams and Pianalto will become voters. They are more neutral, but Pianalto has leaned a bit to the dovish side. Overall the change will lead to a turn in a more dovish direction, which will render it more likely that Fed will ease more if new negative shocks hit the economy.

FOMC statement from 13 December 2011

Information received since the Federal Open Market Committee met in November suggests that the economy **has been expanding moderately**, notwithstanding some apparent slowing in global growth. While indicators point to **some improvement in overall labor market conditions**, the unemployment rate remains elevated. Household spending has continued to advance, but business fixed investment appears to be increasing less rapidly and the housing sector remains depressed. Inflation has moderated since earlier in the year, and longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The **Committee continues to expect a moderate pace of economic growth over coming quarters and consequently anticipates that the unemployment rate will decline only gradually** toward levels that the Committee judges to be consistent with its dual mandate. Strains in global financial markets continue to pose significant downside risks to the economic outlook. The Committee also anticipates that **inflation will settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate.** However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations.

To support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate, **the Committee decided today to continue its program** to extend the average maturity of its holdings of securities as announced in September. The Committee is maintaining its existing policies of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. **The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate**.

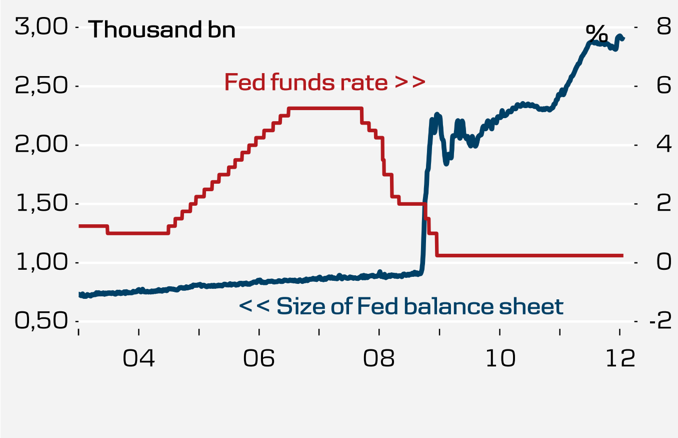
The Committee also decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are **likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013**.

The Committee will continue to assess the economic outlook in light of incoming information and is prepared to employ its tools to promote a stronger economic recovery in a context of price stability.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Richard W. Fisher; Narayana Kocherlakota; Charles I. Plosser; Sarah Bloom Raskin; Daniel K. Tarullo; and Janet L. Yellen. Voting against the action was Charles L. Evans, who supported additional policy accommodation at this time.

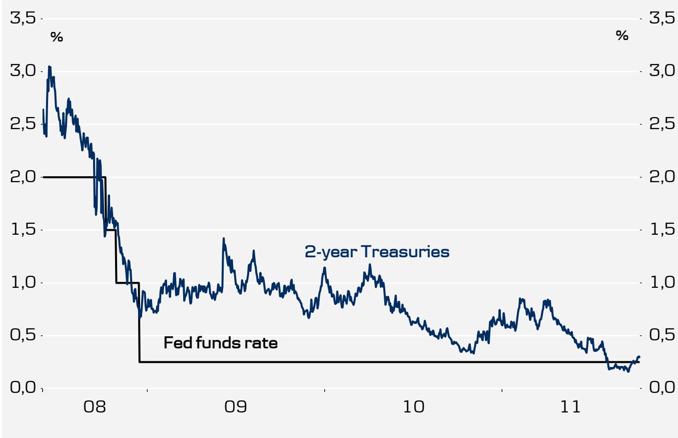
FOMC chart book

Fed keeps balance sheet stable



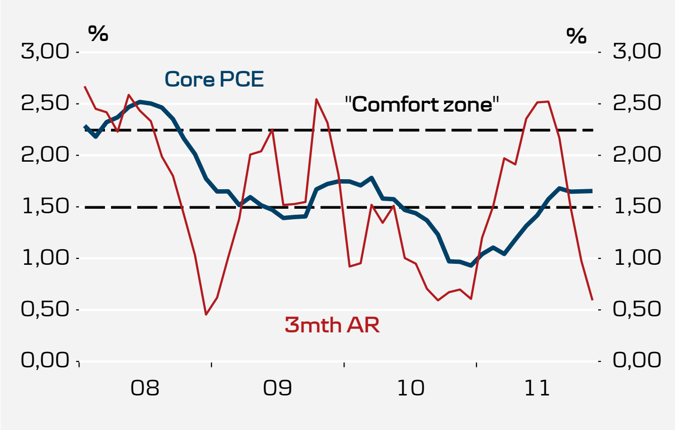
Source: Reuters EcoWin

Bond yields still at very low levels



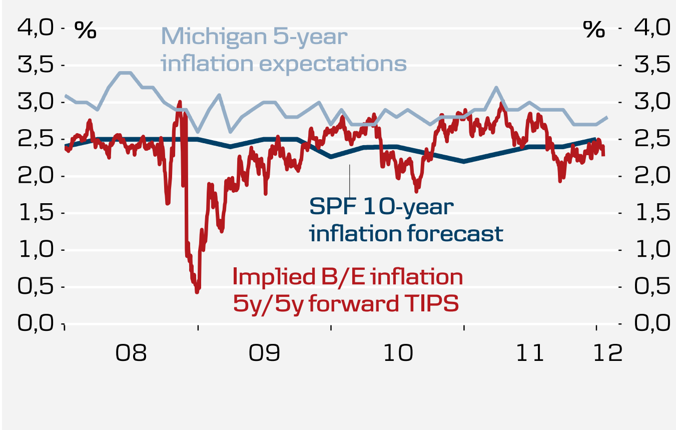
Source: Reuters EcoWin

Core inflation momentum easing



Source: Reuters EcoWin

Inflation expectations have eased

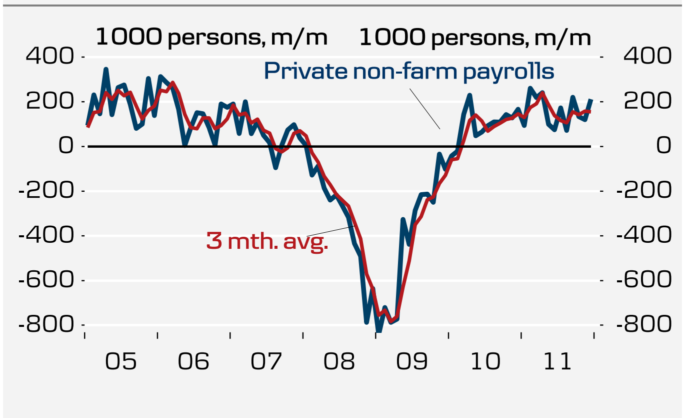


Source: Reuters EcoWin

Stabilisation in ISM is easing recession concerns

Source: Reuters EcoWin

Labour market stabilising



Source: Reuters EcoWin

FOMC ornithology – January 2012

HAWKISH

Lacker	Richmond	**Voter**
Plosser	Philadelphia	**Non-voter**
Fisher	Dallas	**Non-voter**
Kocherlakota	Minneapolis	**Non-voter**

NEUTRAL

Duke	Board member	Voter
Williams	San Francisco	**Voter**
Bullard	St. Louis	Non-voter
Pianalto	Cleveland	**Voter**
Lockhart	Atlanta	Voter
Tarullo	Board member	Voter
Raskin	Board member	Voter
Bernanke	Chairman	Voter

DOVISH

Cumming	New York	Non-voter
Dudley	New York	Voter
Yellen	Board member	Voter
Evans	Chicago Fed	**Non-voter**

Bold means change in voting status in 2012

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