



## KBC Flash

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### FOMC statement aims to be boring

- ...Fed recognizes the improvement in the labour market....
- ...and the pick up in household spending, while...
- ... still anticipating exceptional low Fed funds rate for an extended period of time
- ... Governor Hoenig dissents again on the issue of the forward-looking guidance

The FOMC concluded its meeting with the release of a statement that showed no surprises and very few changes, which was probably what chairman Bernanke had in mind ahead of the meeting. The recovery is ongoing and the Fed wants to give it all the time to broaden and strengthen. There was no need yet to give the market food to speculate on a change in the monetary policy settings. Especially not in the face of renewed market turmoil, be it in the EMU bond market. So, the statement of five paragraphs contained only three material changes in the assessment on the economy, which were very much in line with the economic data released since the previous meeting. As a result, market moves after the release were subdued.

#### Incremental upgrade of eco outlook

The FOMC repeated that economic activity continued to **strengthen**, similar to the January statement and notes improvement in three specific areas. The FOMC said the labour market is improving, while in March it described it as stabilizing, but adding that employers remain reluctant to add to payrolls. Secondly, household spending was seen picking up recently, while in March it was described as expanding at a moderate pace. Finally the FOMC recognized that housing starts have edged up, but remained at a depressed level, while previously starts were called flat at a depressed level. These changes corroborate with the strength in the latest labour market, retail sales and housing starts reports. Importantly though, the FOMC didn't see these changes as important enough to upgrade its outlook of the economy. **“Although the pace of the economic**

**recovery is likely to be moderate for a time, the Committee anticipates a gradual return to higher levels of resource utilization in the context of price stability.”** Despite the Fed reluctance to upgrade its outlook, these improvements point to a broadening of the recovery which is a meaningful change in the economy.

#### No changes in inflation assessment

The assessment of inflation wasn't changed. **“Inflation is likely to be subdued for some time”**. The FOMC probably has a balanced view and sees neither inflation nor deflation risks.

#### Rates very low for extended period

While the FOMC statement contained some hints that the economic environment is slowly changing for the better and thus monetary policy may be adapted at some point in the future, **the FOMC clearly signalled that such a change in policy is not around the corner**. So it kept its famous forward looking guidance saying that *“economic conditions,...., are likely to warrant exceptionally low levels of the federal funds rate for an extended period.”* Ahead of the meeting, various governors, who hinted before that they had second thought about the need to retain the forward looking guidance, had rallied behind the chairman's view that there was no reason to change the language. However, the Minutes of the March meeting signalled a softening in the interpretation of the guidance. Indeed, it should not be interpreted as meaning that rates would be exceptionally low for a specific



period of time (some governors had defined it previously as 3-to-4 FOMC meetings). Now it was suggested that the phrase meant that the economic situation was the referee for the duration of the period of exceptional low rates. So, there were no surprises on this (unchanged) part of the statement. In the final paragraph, the FOMC said that "the Federal Reserve has closed all but one of the special liquidity facilities, something which was of course stating the obvious. .

### Governor Hoenig dissents

Kansas Fed governor Hoenig who "represents" the so-called hawkish wing inside the FOMC dissented for the third meeting on the subject of the forward looking guidance, which he found no longer warranted while "it could lead to the **buildup of financial imbalances and increase risks to longer-run macroeconomic and financial stability**. He added this time that the phrase limited "**the Committee's flexibility to begin raising rates modestly**." This suggests that Hoenig is leaning now towards raising rates.

### Nothing on the exit policy or asset sales

Two important items weren't mentioned in the statement, neither were they in previous statements though. Firstly, the way the exit policy will be implemented and the progress being made regarding the new tools like the term deposit facility, the interest rate on excess reserves and the reverse repos. There was also nothing about the fate of the assets the Fed bought during the crisis, which is currently subject to debate inside the FOMC. Will there be an asset sale program to lighten the balance sheet, as some governors seems to think? We probably get more information on these when the Minutes of the FOMC meeting will be published.

### FOMC statement April 28

Information received since the Federal Open Market Committee met in March suggests that economic activity has continued to strengthen and that the labor market is beginning to improve. Growth in household spending has picked up recently but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software has risen significantly; however, investment in nonresidential structures is declining and employers remain reluctant to add to payrolls. Housing starts have edged up but remain at a depressed level. While bank lending continues to contract, financial market conditions remain supportive of economic growth. Although the pace of economic recovery is likely to be moderate for a time, the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability.

With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to be subdued for some time.

The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period. The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability.

In light of improved functioning of financial markets, the Federal Reserve has closed all but one of the special liquidity facilities that it created to support markets during the crisis. The only remaining such program, the Term Asset-Backed Securities Loan Facility, is scheduled to close on June 30 for loans backed by new-issue commercial mortgage-backed securities; it closed on March 31 for loans backed by all other types of collateral.

### Our Fed view is unchanged

The cyclical recovery will gradually strengthen further, which will make the current accommodative stance inappropriate at some point in the future. Given the experience of the past where keeping rates too easy for too long setting the stage for the bubbles that put the world economy on the verge of collapse, we favour a rather fast first move of the Fed that will show its resolve not to let things once more run out of hand (see arguments Hoenig). We identified the three last meetings of 2010 as likely moments in which rates might be raised and choose the September FOMC meeting as the most likely one. While we are aware that it is an aggressive call and risks of a delay are obvious, we won't change our adjustment at this stage. After one or two rate hikes the FOMC would take a pause to assess the situation as fiscal policy will start exercise some restraint. So, there won't be an aggressive Fed in the next twelve months at the least.

### Market reaction subdued

The money and fixed income market reacted barely. The curve very slightly steepened, which looks logical. The dollar marginally weakened against euro and strengthened slightly versus yen. Similarly, equities gained a few ticks. However, all moves were in fact insignificant.

Piet Lammens KBC

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Elizabeth A. Duke; Donald L. Kohn; Sandra Pianalto; Eric S. Rosengren; Daniel K. Tarullo; and Kevin M. Warsh. Voting against the policy action was Thomas M. Hoenig, who believed that continuing to express the expectation of exceptionally low levels of the federal funds rate for an extended period was no longer warranted because it could lead to a build-up of future imbalances and increase risks to longer run macroeconomic and financial stability, while limiting the Committee's flexibility to begin raising rates modestly.

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