



## KBC Flash

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### Dovish FOMC 'promises' zero rates for three more years!

**Fed remains very cautious on economic outlook....**

**Sees downside risks to inflation.....**

**Downside financial risks significant**

**Defines price stability objective as a 2% annual change in PCE deflator**

**Inflation and maximum employment objective have equal weight**

**Fed still pondering additional QE-3 accommodation**

**Continues operation twist and re-investing maturing assets**

**But most importantly anticipates very low rates at least through late 2014**

**Modest market reaction suggest dovish outcome largely anticipated**

In a historical meeting, **the FOMC took a number of far-reaching changes to the way it will model and communicate its policy.** It specified for the first time ever its price stability objective as a 2% annual rate of change in the price index for personal consumption expenditure. It also confirmed the equal weight of its inflation and maximum employment objective. Also for the first time ever, the Fed published the interest rate projections of individual governors for the first interest rate increase and their estimate of rates for the Q4 of the next years.

Besides these institutional changes, which will only be fully understood in the following years, **the FOMC delivered also a very dovish message on near term monetary policy prospects. First, the Fed remains very cautious on the economic outlook** and qualifies the downside financial risks to the

economic outlook as significant, while remaining cautious in describing the recent economic improvement. **Second, a subtle change in the inflation part of the statement suggests that downside risks on inflation might become a theme.**

Third, the FOMC anticipates very low rates **through late 2014.** That is 1.5 years beyond mid 2013, the previous conditional promise of the Fed. This actually is an important easing of policy.

Fourth, **the interest rate projections show that besides the 5 governors that see a first rate hike in 2014, 4 see a first rate hike only in 2015 and 2 in 2016.** Admittedly, 3 governors see a rate hike in 2012 and 3 in 2013. However, it is very likely that those estimates are coming from regional governors



that have not always a vote at the FOMC deliberations.

Finally and most important, **chairman Bernanke, whose view matters most, sounded very dovish in his comments and suggested that the question of more accommodation is on the table.**

## Market reactions

US Treasuries jumped on the decisions, but the longer end was later on hit by profit taking. Not surprisingly, the belly of the curve outperformed with the 5-year doing better than 3- and 7-year and the 7 doing better than the 10-year. The 30-year was little changed at the end of the day. The dollar was sold, equities gained and so did gold and commodities.

## More detailed assessment

### Cautious on the eco outlook...

The FOMC description of the economic conditions didn't contain many changes vis-à-vis the previous meeting, but was slightly more upbeat on the recent economic data. "*Information received since the Federal Open Market Committee met in December suggests that the economy has been expanding moderately, notwithstanding some slowing in global growth*". It remained however cautious on the outlook, which contained only one change versus the December FOMC statement. Now it states that **business investment has slowed**, while in December it was described as follows: "appears to be increasing less rapidly". In the current statement the FOMC said to expect growth to be modest over coming quarters. The statement also mentioned that strains in global financial markets posed significant downside risks to growth.

### .. Warning on too slow inflation

The FOMC said *that inflation has been subdued in recent months*, while in the December

statement it said that *"inflation appears to have moderated since earlier in the year"*.

The FOMC said it anticipates that *over coming quarters, inflation will run at levels at or below those consistent with the Committee's dual mandate*. In December, it said it anticipates that inflation will **settle**, over coming quarters at levels at or below those consistent with its dual mandate.

While changes are subtle, it seems that the FOMC sees more risk for an undershooting of its inflation objective. This might become important if indeed inflation would cool more and offer the FOMC the justification to start another QE programme at a later stage. This was confirmed in the press conference, as Bernanke several times said that more accommodation was not excluded.

## At last an numeric inflation target

Besides the traditional FOMC statement, the Federal Reserve published a statement on the principles regarding its longer term goals and monetary policy strategy. The aim is to enhance transparency and predictability.

As inflation over the longer term is primarily determined by monetary policy, the Fed is able to specify a long-run goal, notably a **2% annual change in the price index for personal consumption expenditures**.

As the maximum level of employment is largely determined by nonmonetary factors, it isn't appropriate to set a specific goal for employment. However, the FOMC is guided by an assessment of the longer-run normal rate of unemployment. The latter may vary over time. Currently such a rate is estimated between 5.2% and 6%.

The Fed underlines that it gives equal weight to both objectives. The FOMC seeks to mitigate deviations of inflation and unemployment from their longer-run goal of inflation and their assessment about maximal employment. If these deviations are not complementary, the FOMC in setting policy takes into account the



magnitude of the deviation and the potentially different time horizons over which inflation and employment are projected to return to levels judged consistent with the mandate.

## FOMC expects low rates for longer

The FOMC expects to maintain a highly accommodative stance for monetary policy. It specifies that it keeps the Fed Funds target rate between 0% and 0.25% and anticipates that economic conditions are likely to warrant exceptionally low levels for the Federal Funds rate **at least through late 2014**. Until now, it expected low levels until mid 2013. **So it prolonge this period by 1.5 years, which can be considered as an substantial additional easing of policy**. One regional governor, Mr. Lacker of the hawkish wing, dissented against this part of the decision. He preferred to omit the description of the time period. So, he didn't necessarily dissent against keeping rates low for a prolonged, but not specified, period.

## Rate projections reveal particularities

Chairman Bernanke specified that the individual projections were posted before the FOMC meeting and also distributed to the governors before the meeting and used as an input for the discussions. **In this respect, the late 2014 (collective) decision of the FOMC was not entirely in lockstep with the revelations of the individual rate projections**. Indeed, the chart of the individual projections show that by end 2014, only 6 governors of the 17 expected an unchanged rate, 5 expected a FF of 0.5% to 1%, one expected a 1.5% rate and 6.2% or more. In the first rate increase projections, 3 governors saw a first rate increase in 2012 and 3 in 2013, while 5 projected a rate increase in 2014 and 4, respectively 2 in 2015 and 2016.

Various explanations are possible: the expression very low FF rate may not mean at the current rate, but may eventually mean below 1%, in which case 11 of the 17 governors may

have agreed with the end of 2014 indication. It may also be that the voting members (10) were mainly those who favoured a rate hike in 2014 or later, thus securing a majority for the late 2014 assessment for the first rate hike in the FOMC statement. As the FOMC decision was taken after deliberations, some governors who had projected a rate increase before late 2014 may have agreed by the finally adopted time frame.

The growth, inflation and unemployment rate projections were little changed compared to November. Inflation is expected to remain subdued and between 1.5 and 2%. The unemployment rate projections were lowered a bit, but at 6.7% to 7.6% for 2014 stayed well above the 5.2% to 6% long-run unemployment. **Reporters asked Bernanke why no new accommodation measures were taken, given 2014 unemployment and inflation estimates**. Bernanke acknowledged that this suggests that more accommodation may be needed, especially should the decline in unemployment slow again or if inflation would drop further below the projections. To us, it looked like another QE-programme has a reasonably good chance to be adopted in one of the next few meetings.

The Minutes of the FOMC meeting will contain some indications about the size of their balance sheet expected by the governors. This might give us more indications about the chances and timing of more quantitative easing.

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<http://www.federalreserve.gov/newsevents/press/monetary/20120125c.htm> (objectives)

<http://www.federalreserve.gov/newsevents/press/monetary/20120125b.htm> (eco projections)

<http://www.federalreserve.gov/newsevents/press/monetary/20120125a.htm> (FOMC statement)





## Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, January 2012

Advance release of table 1 of the Summary of Economic Projections to be released with the FOMC minutes

Percent

Variable	Central tendency <sup>1</sup>				Range <sup>2</sup>			
	2012	2013	2014	Longer run	2012	2013	2014	Longer run
Change in real GDP . . . . .	2.2 to 2.7	2.8 to 3.2	3.3 to 4.0	2.3 to 2.6	2.1 to 3.0	2.4 to 3.8	2.8 to 4.3	2.2 to 3.0
November projection . . . . .	2.5 to 2.9	3.0 to 3.5	3.0 to 3.9	2.4 to 2.7	2.3 to 3.5	2.7 to 4.0	2.7 to 4.5	2.2 to 3.0
Unemployment rate . . . . .	8.2 to 8.5	7.4 to 8.1	6.7 to 7.6	5.2 to 6.0	7.8 to 8.6	7.0 to 8.2	6.3 to 7.7	5.0 to 6.0
November projection . . . . .	8.5 to 8.7	7.8 to 8.2	6.8 to 7.7	5.2 to 6.0	8.1 to 8.9	7.5 to 8.4	6.5 to 8.0	5.0 to 6.0
PCE inflation . . . . .	1.4 to 1.8	1.4 to 2.0	1.6 to 2.0	2.0	1.3 to 2.5	1.4 to 2.3	1.5 to 2.1	2.0
November projection . . . . .	1.4 to 2.0	1.5 to 2.0	1.5 to 2.0	1.7 to 2.0	1.4 to 2.8	1.4 to 2.5	1.5 to 2.4	1.5 to 2.0
Core PCE inflation <sup>3</sup> . . . . .	1.5 to 1.8	1.5 to 2.0	1.6 to 2.0		1.3 to 2.0	1.4 to 2.0	1.4 to 2.0	
November projection . . . . .	1.5 to 2.0	1.4 to 1.9	1.5 to 2.0		1.3 to 2.1	1.4 to 2.1	1.4 to 2.2	

NOTE: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The November projections were made in conjunction with the meeting of the Federal Open Market Committee on November 1–2, 2011.

1. The central tendency excludes the three highest and three lowest projections for each variable in each year.
2. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.
3. Longer-run projections for core PCE inflation are not collected.

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