

## The FOMC Reaffirmed Dovish Stance, As The Fed's US Outlook Turns More Cautious

- The Fed keeps its ultra-low interest rate policy unchanged but lowered its US growth and unemployment outlook, inflation is revised higher but still benign
- The end of QE2 in June remains on track, no additional easing measures in the pipeline despite the Fed's softer economic outlook
- We believe that weaker growth and the persistently high unemployment could keep the Fed on holding longer with the first interest rate hike only in early 2013

The US Federal Reserve's FOMC meeting and the second post-meeting news conference yesterday (Wednesday 22 June/Thursday morning in Singapore) turned out to be in line with expectations and reaffirmed the Fed's dovish monetary policy stance as the Fed deemed the economic conditions "are likely to warrant exceptionally low levels for the federal funds rate for an extended period". The decision was unanimous.

To recap, the post-meeting statement noted that the US economic recovery "is continuing at a moderate pace, though somewhat more slowly than the Committee had expected" and "recent labor market indicators have been weaker than anticipated". The Fed also noted that while growth is slowed down by some temporary factors (like high commodity prices, and Japan earthquake related supply disruption), there are some other more persistent headwinds that is slowing growth that the Fed does not "have a precise read on". Recent US data continues to be weak (especially the jobs and housing market) suggesting that while we are still not expecting a double-dip, the US growth recovery could turn out to be more gradual than what was anticipated at start of 2011.

Indeed, the Fed lowered again its central tendencies for its growth outlook in 2011 and 2012 (from the April's forecast) and also adjusted higher its PCE inflation forecasts for 2011. (Table 1) The Fed's growth outlook has been revised lower for 2011 to 2.7-2.9% (from 3.1-3.3%), while GDP growth in 2012 is now forecast at 3.3-3.7% (from 3.5-4.2%). The Core PCE Inflation forecast is raised 1.5-1.8% (from 1.3-1.6%). The Fed also expects the easing of the unemployment rate to be delayed, to average 8.6-8.9% in 4Q-2011 (from April's projection of 8.4-8.7%), unemployment rate will ease to 7.8-8.2% in 4Q-2011 (from previous estimates of 7.6-7.9%). In general, the Fed expects a weaker outlook for the US, while inflation developments remain benign (although adjusted slightly higher) as inflation expectations remain well anchored.

As for the Fed's US\$600bn Treasury purchase program (QE2), QE2 is still scheduled to be completed by end June this month, and with deflation no longer a credible risk, no QE3 is expected although Bernanke commented that the Fed has options to further stimulate the economy, such as undertaking additional bond purchases or strengthening its commitment to holding rates lower for longer.

Quantitative easing (QE) is an unconventional monetary policy tool used by some central banks to stimulate the economy when conventional monetary policy via interest rates has been exhausted. QE works through two channels. This first channel is through portfolio rebalancing. QE is like an asset swap and is implemented by the central bank's purchase of financial assets from banks with newly created money, thereby increasing the excess reserves in the banking system. QE does not directly increase lending activities but rather increasing the reserves held by banks in hope of encouraging banks to expand their loans programmes and therefore reducing the banks' reserves. The second channel is through psychological expectations. Simply put, if everyone believes that QE will work then QE works. However, if no one believes QE will work then QE fails.

Note that QE works via a stock effect and not flow effect. The US fed has expanded its balance sheet aggressively under the two QE programmes by more than 190% to US\$2.6tn. And as the Fed is expected to take its time to reduce its balance sheet, so the easing effect of QE 1 and 2 will still be felt by the banking system in the future quarters even as QE2 ends in June. And even as the QE2 concludes at end-June, the stimulus effect of QE will not stop completely as the Fed will still continue to reinvest maturing debt (which may amount to US\$12-16bn monthly, according to market estimates).

That said, QE3 cannot be ruled out completely but the bar has been set very high (by the Fed) for QE3 to be rolled out. There are still plenty of things that can go wrong, and if they do, either individually or as a double (or even triple whammy) then the Fed may have to implement additional easing. Worry spots include a US double dip, MENA engulfed by unrest which leads to oil price spikes, financial contagion from the Euro-zone debt crisis, a China hard landing and a sudden worsening in Japan's nuclear crisis.

With growth falling short of expectations and risks skewed to the downside, we are not expecting the Fed to normalize its ultra-loose monetary policy any time soon. Nonetheless, as disinflation is no longer a key Fed concern, more monetary easing via QE is also not on the cards any time soon. As the Fed has its dual mandates on both employment and price stability, the lacklustre economic growth and persistently high unemployment rate (against the backdrop of well-anchored long term inflation expectations) is likely to keep the Fed on hold for longer, and we now expect the first hike in the Fed funds target rate (FFTR) only in 1Q-2013 (from 3Q-2012 previously).

Table 1: FED's Growth Outlook Is Increasing Gloomy While Inflation Edges Up				
Economic Projections of US Federal Reserve Board, June 2011				
Variable	Central Tendency (%)			
	2011	2012	2013	Longer Run
Change in real GDP	2.7 - 2.9	3.3 - 3.7	3.5 - 4.2	2.5 - 2.8
April projection	3.1 - 3.3	3.5 - 4.2	3.5 - 4.3	2.5 - 2.8
January projection	3.4 - 3.9	3.5 - 4.4	3.7 - 4.6	2.5 - 2.8
Unemployment rate	8.6 - 8.9	7.8 - 8.2	7.0 - 7.5	5.2 - 5.6
April projection	8.4 - 8.7	7.6 - 7.9	6.8 - 7.2	5.2 - 5.6
January projection	8.8 - 9.0	7.6 - 8.1	6.8 - 7.2	5.0 - 6.0
PCE inflation	2.3 - 2.5	1.5 - 2.0	1.5 - 2.0	1.7 - 2.0
April projection	2.1 - 2.8	1.2 - 2.0	1.4 - 2.0	1.7 - 2.0
January projection	1.3 - 1.7	1.0 - 1.9	1.2 - 2.0	1.6 - 2.0
Core PCE inflation	1.5 - 1.8	1.4 - 2.0	1.4 - 2.0	
April projection	1.3 - 1.6	1.3 - 1.8	1.4 - 2.0	
January projection	1.0 - 1.3	1.0 - 1.5	1.2 - 2.0	
<i>Source: Federal Reserve</i>				

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