

Thursday, 27 January 2011

Flash Notes

US Macro Policy Mix: FOMC Unchanged Plus 'State of the Union' Cuts

The Fed FOMC kept its benchmark fed funds target rate unchanged, extended period language was maintained and kept its \$600bn asset purchase programme intact with end date of 2Q 2011. Interestingly, no votes against the policy despite four new regional reserve bank presidents rotated into the FOMC. New additions, Charles Plosser and Richard Fisher, who have tended to be hawkish, did not dissent.

Overall, no significant change in the statement but the new additions to the statement released yesterday highlighted a slight shift towards some concern about future inflationary concerns via the pass-through from global commodity prices. At the same time there is also a slight shift in the language towards a focus on incremental changes in labour conditions (non-farm payrolls maybe) as an indicator to look out for rather than the unemployment rate. This shows to some extent maybe that the threshold unemployment rate can remain high, before a move towards a 'hawkish' bias. Statement also indicated that consumer spending "picked up late last year" and that investment in software and equipment is "rising" without the qualifier that the pace of this spending by businesses has slowed relative to earlier last year. Housing was described as being "depressed" again, and employers are still "reluctant to add to payrolls".

Today's statement again mentioned that the progress toward its mandated goals of full employment and price stability has been disappointing and reaffirms unwinding the components of the current highly stimulative monetary policy once conditions in the labour market are deemed to be on firmer ground. The low level of core inflation, which only inched higher in the final months of 2010 to 0.8%, also argues against the Fed making any adjustments toward less accommodation any time soon. However, following the BOE Governor Mervyn King's recent speech in Newcastle and BOE's MPC hawkish minutes yesterday, it shows the possible future dilemma developed central banks such as BOE, ECB and even the Fed may eventually face - the risk of an environment of sluggish growth but eventual high or rising inflation rates down the road. We still hold the view that the Fed is likely to keep its policy rate at the 0-0.25 range until Q4 2011 before probably hiking in 2Q 2012.

Going forward, following this statement, we expect this Friday's 4Q 2010 real US GDP report to produce very mild upgrade to the Fed's forecast as it has somewhat acknowledged that some areas of the economy are in the process of strengthening. The consensus forecast is for 4Q 2010 real GDP growth of 3.5% at an annualized pace. The Fed statement appears to be very cautious about the view that an acceleration in growth is a done deal and that policy needs to be altered. The statement highlights that policymakers remain worried about the high level of unemployment and the fact that inflation measures "have been trending downward."

On the US fiscal front, fiscal policy remains key for the US economy in 2011. The recent 2011 State of the Union highlighted some positive news on the fiscal front, but how soon it will be implemented and how effective it is one the economy is an issue. The freeze on annual domestic spending (discretionary non-defence spending) for next 5 years is expected to reduce the deficit by \$400bn over the next decade. However, these cuts will only account for annual domestic spending which only accounts for a little over 12% of out budget. The projections of a \$6.2tn deficit accumulating in the next few years, still looks somewhat insurmountable. The speech also highlighted further deep cuts to excessive spending, indicated that permanent tax cut extension is out of the question budget-wise and highlighted the need to lower corporate tax rates for the first time in 25 years. The US macro-policy mix is quite important for the US economy given the lack of bullets left in the Fed arsenal.

The dollar lost ground against most major currencies. Positive news from US new home sales seem to be ignored. Following the FOMC communiqué, EUR/USD breached the 1.3700 level, climbing to session-highs of 1.3723. USD/JPY was confined to a tight range, ending flat around 82.20. Meanwhile, the GBP settled noticeably higher against the greenback – above the 1.59 handle, following the speech by BoE Governor King.

Some of the changes in the statement are summarised below to give a sense of the focus of policy deliberations. The rest of the description of the economy is unchanged.

	Inflation	Labour Market (Unemployment)	Output Gap (Excess Capacity)
FOMC	<u>“Although commodity prices have risen, longer-term inflation expectations have remained stable, and measures of underlying inflation have been trending downward.”</u>	“...economic recovery is continuing, though at a rate that has been insufficient to <u>bring about a significant improvement in labour market conditions.</u> ”	“Business spending on equipment and software is rising....” (though less rapidly than earlier in the year – was removed) “ <u>Growth in household spending picked up late last year...</u> ” (compared to “Household spending is increasing at a moderate pace”)
	Dual mandate (Inflation and Employment)		QE parameters
	Unchanged		Relatively unchanged.
FOMC votes against:	None.		

* *underlined represents new additions to statement.*

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