

# Flash Comment

## USA: Fed's deflation fears are easing

- The FOMC statement was less dovish than we had expected. The committee decided to retain the target range for the fed funds rate and leave the size, timing and scope of the Fed's security purchase programmes unchanged.
- In general, the committee has become less worried about deflation and more optimistic on growth. Still, inflation pressures are regarded as absent with slack in the economy set to keep cost pressures in check despite the recent rise in commodity prices.
- The statement repeated that the fed funds rate will be kept at exceptionally low levels for an extended period and sent only a very vague hint on exit strategies. Treasury yields rose following the statement resulting in a slightly steeper curve.
- The Fed still has the opportunity to alter the Treasury purchase program at its August meeting. However, we believe the Fed will remain sidelined with the way now open for higher 10-year yields and further steepening of the yield curve over the coming months.

### Details

The FOMC decided to leave the fed funds rate at the current target range of 0.00-0.25% and maintain existing targets for purchases of MBS, GSE and Treasuries. There was only a very vague hint concerning exit strategies in the statement's very last paragraph stating that "adjustments" to credit and liquidity programs will take place as necessary.

The statement is generally less downbeat on growth saying that "the pace of economic contraction is slowing" and that "household spending has shown further signs of stabilisation". Furthermore, the FOMC sees "businesses making progress in bringing inventories in alignment with sales" and notes that financial conditions have generally improved.

Deflation fears have clearly eased with the statement no longer referring to risks that inflation could fall below rates which best encourage economic growth and price stability. On the contrary, rising commodity prices are noted. Still, the committee expects inflationary pressures to remain subdued with slack in the economy expected to keep cost pressures in check.

With markets already discounting rate hikes in Q1 2010 we had expected the FOMC to make an effort to talk down rate expectations. Although the statement reiterated that "the fed funds rate will be kept at exceptionally low levels for an extended period" this was not enough to alter market expectations.

### Assessment and outlook

The recession has led to a huge output gap in the economy. The unemployment rate has spiked to a level well above the NAIRU. Applying standard Taylor rules suggests the Fed should keep interest rates on hold at least throughout 2010. While we believe that the central bank will move away from the zero bound before then, we expect rate hikes to be off the agenda until the economy has credibly returned to trend growth and unemployment has peaked. We expect the first rate hike in Q3 2010.

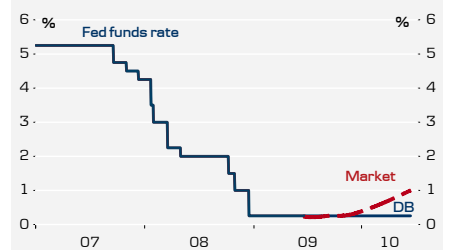
The statement left the door open for changes to asset purchase programs. A scaling up in Treasury purchases can still be effected at the August meeting. However, we expect improved economic indicators, especially in the labour market, to keep the Fed sidelined. As a result, we believe 10-year Treasury yields will increase going forward in line with better economic metrics and more positive financial conditions. While this is likely to result in a steepening of the yield curve over the coming months, as we move closer to 2010 and to the start of rate hikes we expect the curve to flatten.

### FOMC rate decision (June)

	Act	Con	DB	Last
Fed funds	0.13	0.13	0.13	0.13

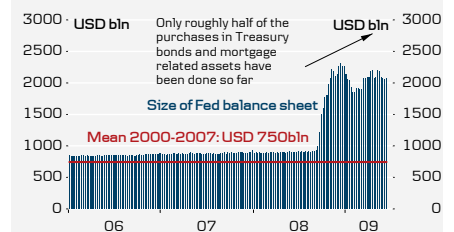
Source: Bloomberg

### Market continue to price rate hikes



Source: Bloomberg and Danske Markets

### No change to purchase programs



Source: Reuters EcoWin

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## Current statement

Information received since the Federal Open Market Committee met in April suggests that the pace of economic contraction is slowing. Conditions in financial markets have generally improved in recent months. Household spending has shown further signs of stabilizing but remains constrained by ongoing job losses, lower housing wealth, and tight credit. Businesses are cutting back on fixed investment and staffing but appear to be making progress in bringing inventory stocks into better alignment with sales. Although economic activity is likely to remain weak for a time, the Committee continues to anticipate that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a gradual resumption of sustainable economic growth in a context of price stability.

The prices of energy and other commodities have risen of late. However, substantial resource slack is likely to dampen cost pressures, and the Committee expects that inflation will remain subdued for some time.

In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability. 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 are likely to warrant exceptionally low levels of the federal funds rate for an extended period. As previously announced, to provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve will purchase a total of up to \$1.25 trillion of agency mortgage-backed securities and up to \$200 billion of agency debt by the end of the year. In addition, the Federal Reserve will buy up to \$300 billion of Treasury securities by autumn. The Committee will continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets. The Federal Reserve is monitoring the size and composition of its balance sheet and will make adjustments to its credit and liquidity programs as warranted.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Charles L. Evans; Donald L. Kohn; Jeffrey M. Lacker; Dennis P. Lockhart; Daniel K. Tarullo; Kevin M. Warsh; and Janet L. Yellen.

## Previous statement

Information received since the Federal Open Market Committee met in March indicates that the economy has continued to contract, though the pace of contraction appears to be somewhat slower. Household spending has shown signs of stabilizing but remains constrained by ongoing job losses, lower housing wealth, and tight credit. Weak sales prospects and difficulties in obtaining credit have led businesses to cut back on inventories, fixed investment, and staffing. Although the economic outlook has improved modestly since the March meeting, partly reflecting some easing of financial market conditions, economic activity is likely to remain weak for a time. Nonetheless, the Committee continues to anticipate that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a gradual resumption of sustainable economic growth in a context of price stability.

In light of increasing economic slack here and abroad, the Committee expects that inflation will remain subdued. Moreover, the Committee sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term.

In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability. The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period. As previously announced, to provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve will purchase a total of up to \$1.25 trillion of agency mortgage-backed securities and up to \$200 billion of agency debt by the end of the year. In addition, the Federal Reserve will buy up to \$300 billion of Treasury securities by autumn. The Committee will continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets. The Federal Reserve is facilitating the extension of credit to households

*and businesses and supporting the functioning of financial markets through a range of liquidity programs. The Committee will continue to carefully monitor the size and composition of the Federal Reserve's balance sheet in light of financial and economic developments.*

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