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## PREVIEW: FOMC JUNE RATE DECISION

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**Current Base Rate: 0.00% to 0.25%**

**Consensus: 0.00% to 0.25%**

- Expect a more sanguine economic outlook, though will likely say recovery to be slow and protracted
- Show a commitment to long term ZIRP (zero interest rate policy) and play down inflation in the near term
- FOMC likely to keep its asset purchase program targets unchanged; though could spring a surprise by altering the size/balance of Treasury and mortgage securities it purchases after the recent spike higher in yields
- FOMC could outline exit strategies for its liquidity programs

The FOMC is widely expected to keep rates on hold this month and refrain from any major policy shifts related to its asset purchase program as economic data points to a stabilization in conditions. However, there has been recent speculation that the Fed may need to raise interest rates sooner rather than later to fend off inflationary pressures. Therefore, the FOMC may use the meeting's statement to emphasise their commitment to low rates for an extended period to quell market concerns.

There is a general consensus among market participants that the FOMC will keep rates on hold until at least 2010 as it does not want to withdraw liquidity at a pace that may prolong, or even jeopardise the recovery. This makes sense, especially as the US unemployment rate nears the 10% mark and lending remains strained amid economic uncertainty. As such, the Fed would be reluctant to raise rates or wind down its asset purchase program until it was convinced the economy was on a sustainable recovery.

### **Economic Data**

US economic data has certainly improved since the FOMC last met. Retail sales rose for the first time in 3 months in May and housing starts/sales, as well as initial jobless claims also provided investors with encouraging signs. GDP for Q1 was down more than expected, however analysts believe Q2 GDP will be down only modestly and Q3 could mark the start of economic growth.

### **Inflation**

The recent rise in Treasury yields reflected the market's worry that inflation could dampen the pace of economic recovery, however after the lower than expected inflation data released last week these fears have subsided for the time being. FOMC members have argued that underlying inflation is not a near-term risk due to the huge amount of slack in the economy. The FOMC said the rise in yields reflected asset reallocation as the economy began to find its footing.

### **Exit Strategies**

The FOMC may seek to reassure the market, especially as worries grow that the Fed may increase rates, by giving an outline of how it will remove the excess liquidity it has pumped in to the financial markets and by letting the market know rates may stay low for the foreseeable future.

### **Market Reaction**

The FOMC may choose to boost their purchases of Treasuries by rebalancing current targets, they could lengthen the process and possibly add a USD 100bln or so to the program. The reaction to such an event could see Treasuries initially move higher as it would signal a cautious outlook and continued purchase of government securities. However, any bid may be short lived as the market could view this move as increasing the chance of inflation, which has been a concern voiced by various market commentators.

The more likely case is that the FOMC may choose to stick with its current asset purchase program size.

Sources: 4Cast/RTRS