

# Flash Comment

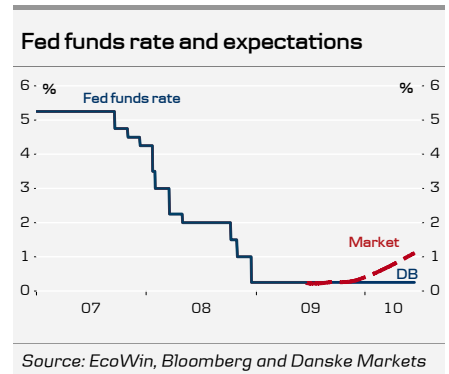
## FOMC: preview of policy meeting

- On Wednesday, at 20:15 CET, the Federal Open Market Committee (FOMC) is set to announce its policy decision. In line with consensus we expect the FOMC to keep the Fed funds rate unchanged in the range of 0.00-0.25%.
- The meeting will be a balancing act. On the one hand, there are members of the FOMC who fear that inflation expectations will run rampant unless the Fed states that it is ready with exit strategies. On the other hand, other members worry about the market's aggressive expectations for interest rate increases and the run up in Treasury and mortgage yields.
- We expect that the FOMC will sound more optimistic on economic outlook but at the same time stress that interest rates will be on hold for a prolonged period as inflationary pressure is expected to be absent for a long time to come.
- Regarding alternative measures, we expect the FOMC to hold the overall size of purchase programmes steady. However, it could choose to adopt a more flexible stance on the composition and the timing of the purchases. This would likely mean buying more Treasuries and less mortgage-related assets. It is difficult to predict the market reaction to such a complex statement but we prefer to be positioned for lower rates.

**Activity:** Economic indicators have in general shown further signs of improvement. Consumer spending has stabilised and housing market indicators suggests that residential construction could be close to a trough. Most importantly though is the recent improvement in labour market indicators. Job losses moderated significantly in May and jobless claims data suggests that the labour market has continued to improve in June. *We expect the statement to acknowledge that the economic outlook has improved further.*

**Inflation:** Commodity prices have moved up over the past six to eight weeks and surveyed inflation expectations have crept marginally higher. Monthly headline inflation has been volatile but core inflation continues to slow. The majority of FOMC members expects underlying inflation pressures to be absent for a long time to come due to the enormous amount of slack in the economy. However, other members fear that inflation expectations will get out of control if the Fed does not send a clear signal about its exit strategies. *The statement will be a balancing act between the two camps. We expect the statement to reiterate that there is "risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term" but could add a comment on exit strategies, stressing that the Fed has the necessary tools to take back liquidity once the economy has fully recovered.*

**Bias and policy outlook:** The recession has led to a huge output gap and the unemployment rate has spiked to a level well above the NAIRU. Even with a pick-up in growth, the output gap will be massive for a long time. Applying standard Taylor rules suggests that the Fed should keep interest rates on hold at least throughout 2010. We believe that the Fed could choose to move away from the zero bound before then, but rate hikes will be off the agenda until the economy has returned convincingly to trend growth and unemployment has peaked. Currently, markets have become too aggressive in their rate hike expectations and are pricing more than 75 basis points in hikes from the Fed over the next 12 months. *We expect the FOMC to talk down the aggressive pricing of rate hikes and reiterate that rates will be held at exceptionally low levels for an extended period. The statement could stress that even though it expects growth to return to positive territory, the output gap will be huge and inflation pressures absent for a long time to come.*



### Probabilities for June 24 meeting

	DB	Market*
Unchanged	100%	100%
Hike to 0.50%	0%	0%

\* Based on options prices as of settlement June 19

Source: Bloomberg and Danske Markets

### Fed funds expectations

Date	DB	Market	Consensus
19/06/09	0-0.25%	0.22%	0-0.25%
+ 3m	0-0.25%	0.27%	0-0.25%
+ 6m	0-0.25%	0.36%	0-0.25%
+ 12m	0-0.25%	1.11%	0.50%

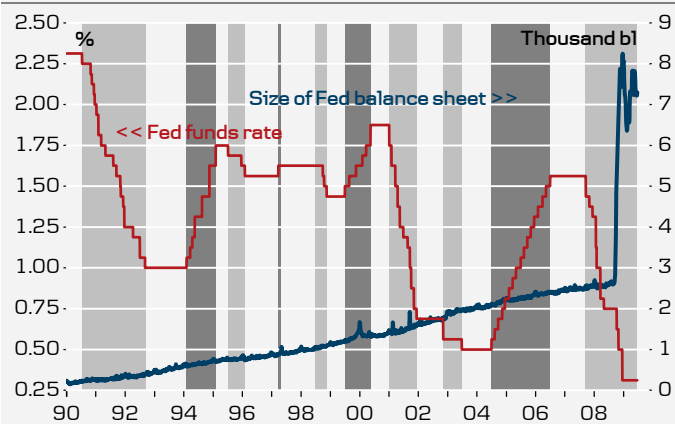
Source: Bloomberg and Danske Markets

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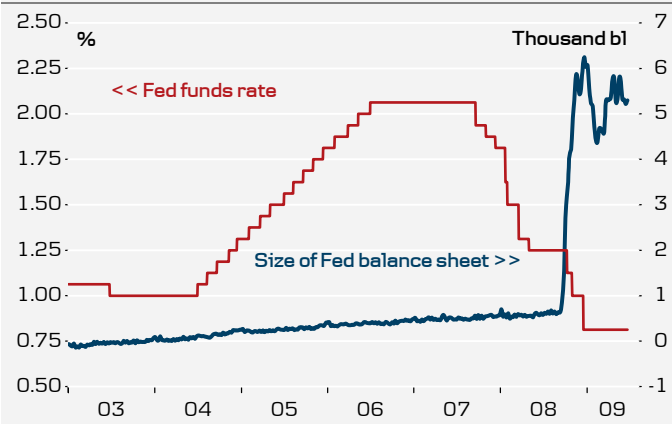
FOMC chart book

Fed to keep ZIRP in place ...



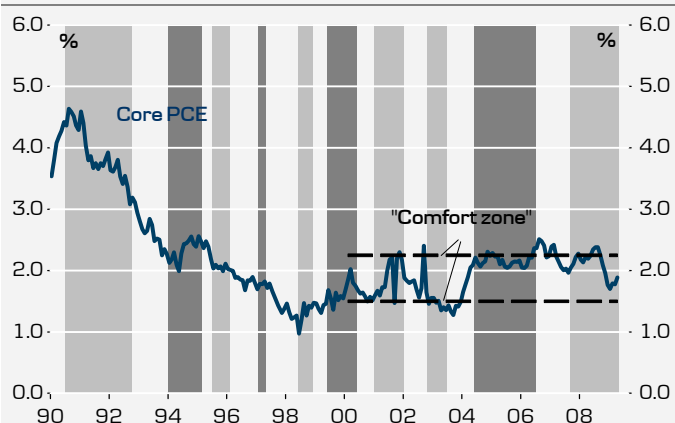
Source: EcoWin and Danske Bank  
 Note: Dark (light) shading indicates periods of tightening (easing)

... but will not expand the overall size of purchase programmes



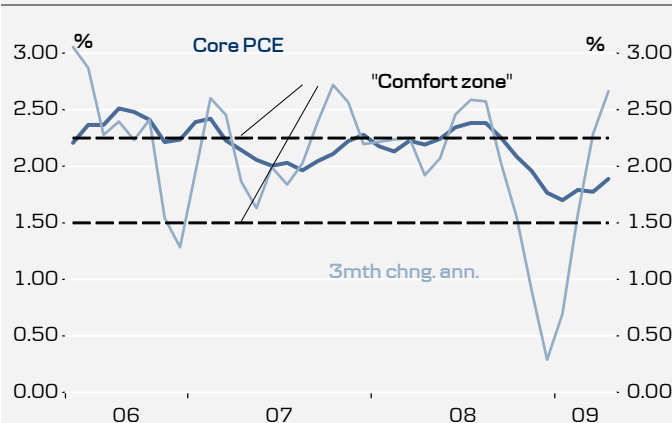
Source: EcoWin

Core PCE inflation is heading south...



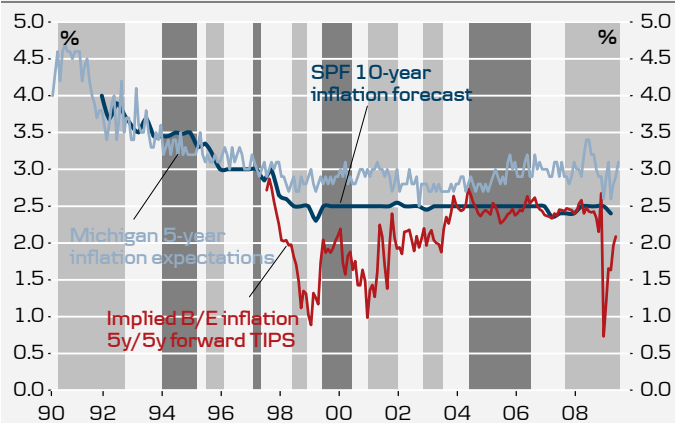
Source: EcoWin and Danske Bank  
 Note: Dark (light) shading indicates periods of tightening (easing)

...moving to the low end of the Fed's comfort zone



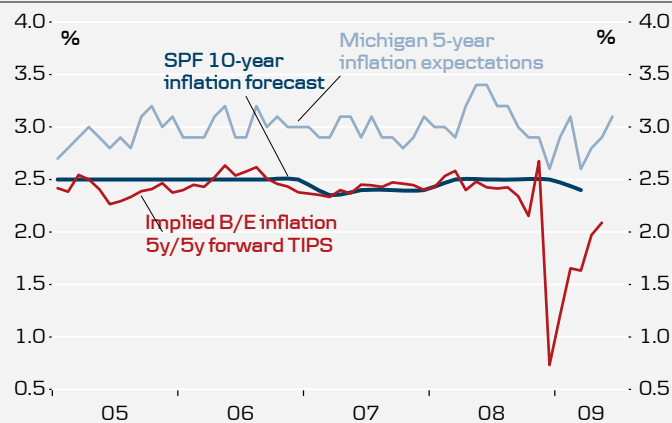
Source: EcoWin and Danske Bank

Long-term inflation expectations have crept higher...



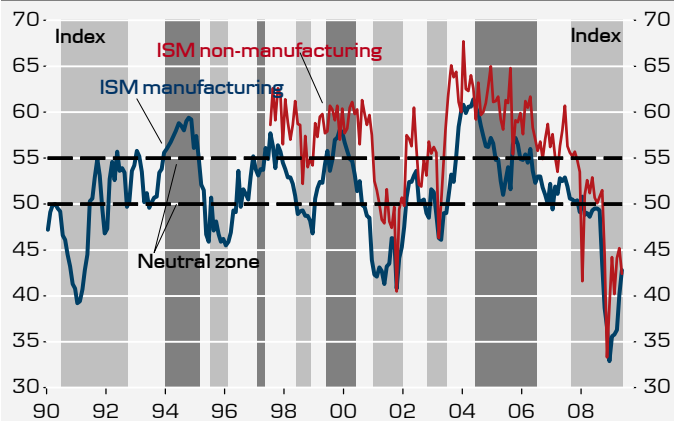
Source: EcoWin and Danske Bank  
 Note: Dark (light) shading indicates periods of tightening (easing)

...and TIPS have returned to more "normal" levels



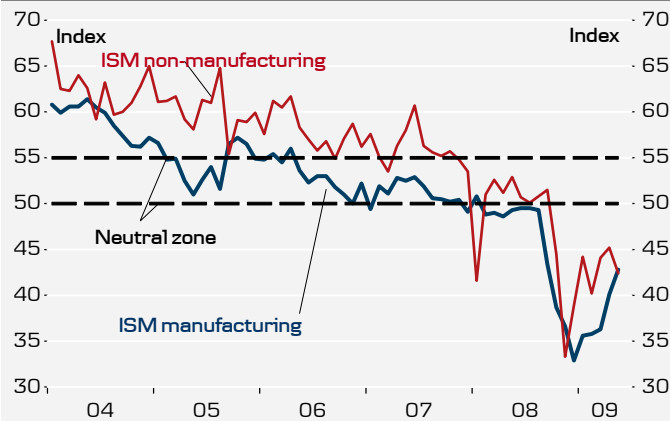
Source: EcoWin and Danske Bank

**Business confidence has turned...**



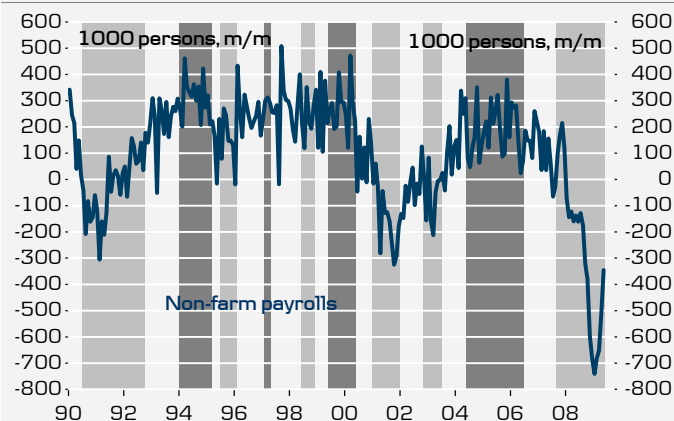
Source: EcoWin and Danske Bank  
 Note: Dark (light) shading indicates periods of tightening (easing)

**...and will continue higher in the coming months**



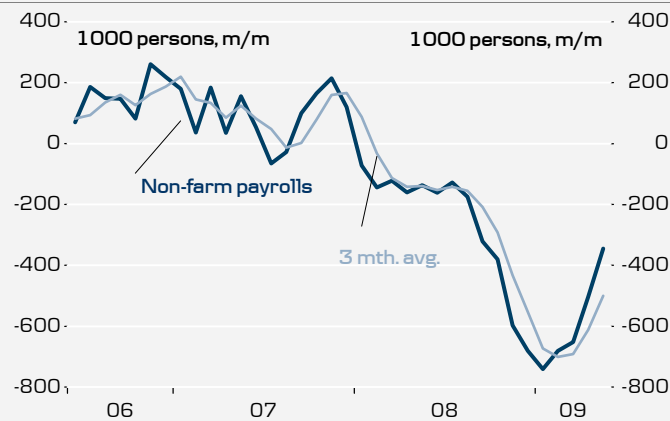
Source: EcoWin and Danske Bank

**Job losses are moderating ...**



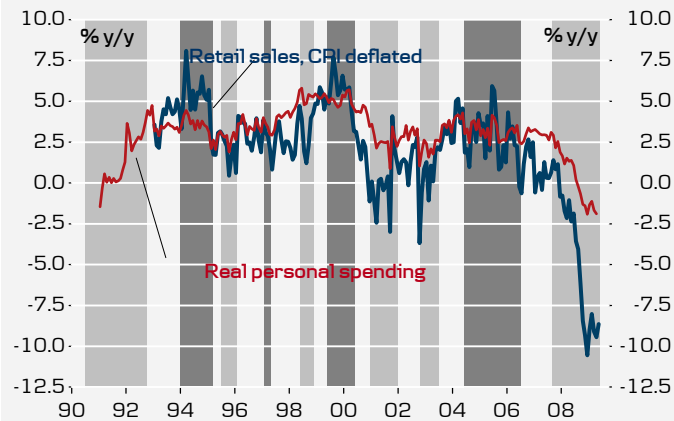
Source: EcoWin and Danske Bank  
 Note: Dark (light) shading indicates periods of tightening (easing)

**... and we should be past the trough**



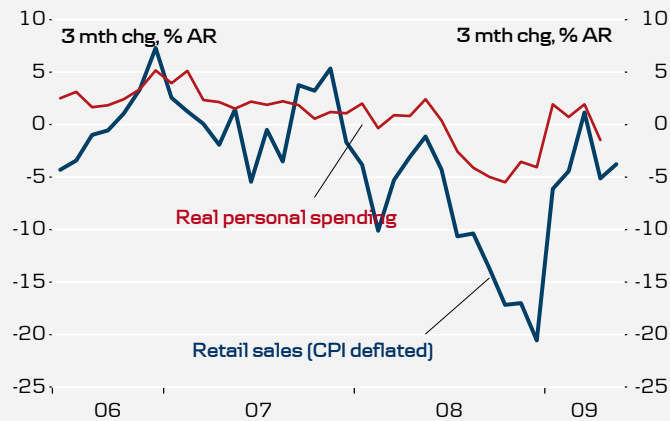
Source: EcoWin and Danske Bank

**Consumer spending has stabilised...**



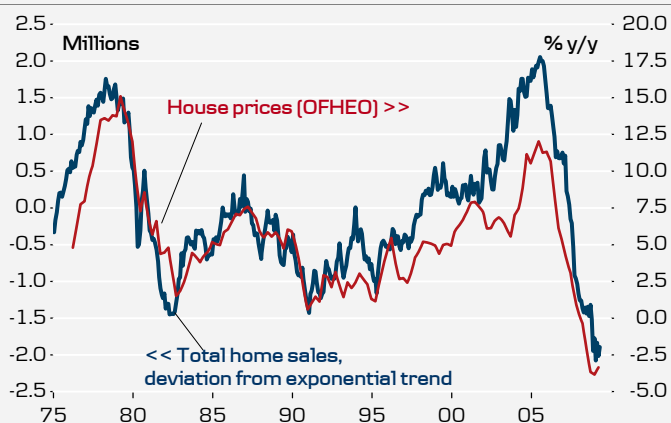
Source: EcoWin and Danske Bank  
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**... following the free-fall in late-2008**



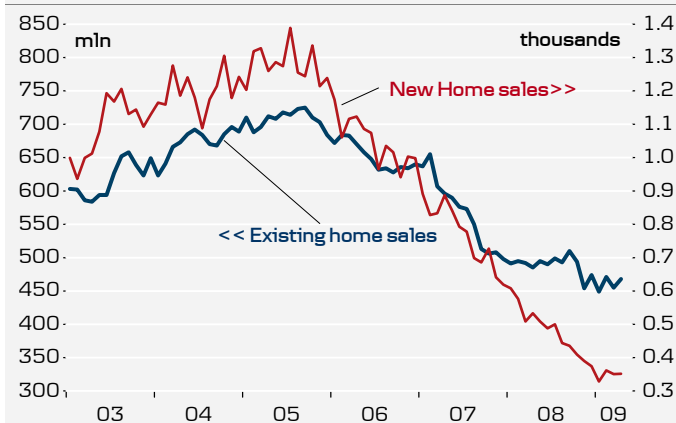
Source: EcoWin and Danske Bank

House prices and home sales...



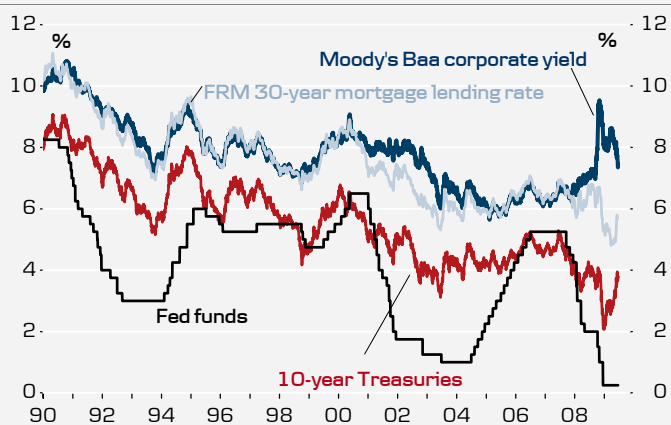
Source: EcoWin and Danske Bank

... are showing signs of stabilisation



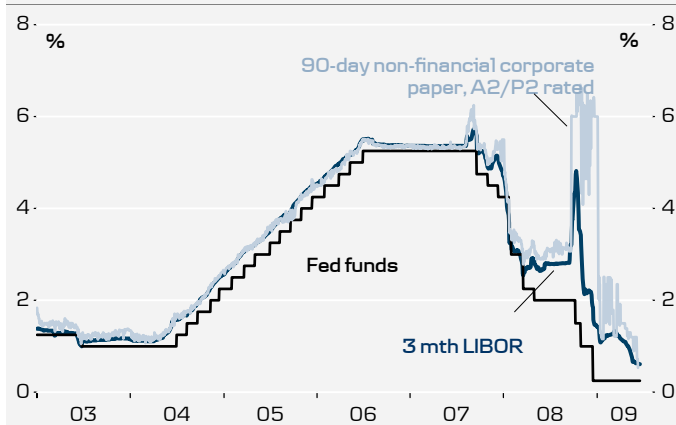
Source: EcoWin and Danske Bank

Treasury and mortgage rates have risen fast



Source: EcoWin and Danske Bank

Fear of systemic risk has eased



Source: EcoWin and Danske Bank

## FOMC key statements

### Statement from April 28-29 meeting:

Information received since the Federal Open Market Committee met in March indicates that the economy has continued to contract, although the pace of contraction appears to be somewhat slower. Household spending has shown signs of stabilising 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 stabilise 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 slackening both 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 0-0.25% 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 USD1.25 trillion of agency mortgage-backed securities and up to USD200bn of agency debt by the end of the year. In addition, the Federal Reserve is expected to buy up to USD300bn of Treasury securities by the 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 programmes. 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.

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.

See Flash comment [FOMC less downbeat on growth](#)

#### Key extracts from April 29-29 minutes:

Although the near-term economic outlook had improved modestly since March, participants emphasised the tentative nature of the incoming data, which are volatile and subject to revision. Moreover, participants continued to see significant downside risks to the economic outlook. In particular, while financial strains and risk spreads had lessened somewhat over the intermeeting period, participants agreed that the global financial system remained vulnerable to further shocks.

Most participants expected inflation to remain subdued over the next few years, and they saw some risk that elevated unemployment and low capacity utilisation could cause inflation to remain persistently below the rates that they judged as most consistent with sustainable economic growth and price stability. However, price inflation had been above the low rates observed late last year, and survey measures of longer-run inflation expectations had remained reasonably stable, leading many participants to judge that the risk of a protracted period of deflation had diminished. Some participants highlighted the potential pitfalls of making inflation projections based on contemporaneously available measures of resource slackening, especially during periods when the economy was facing large supply shocks and significant sector reallocation. Several participants referred to contacts who had expressed concerns that the expansion of the Federal Reserve's balance sheet might not be reversed in a sufficiently timely manner and hence that inflation could rise above rates consistent with price stability.

Some members noted that a further increase in the total amount of purchases might well be warranted at some point to spur a more rapid pace of recovery – all members concurred with waiting to see how the economy and financial conditions respond to the policy actions already in train before deciding whether to adjust the size or timing of asset purchases.

See flash comment [FOMC: no discussion of exit strategies](#)

## FOMC ornithology

<b>HAWKISH</b>						
↑	{	Plosser	Philadelphia	Non-voter		
		Lacker	Richmond	Voter		
		Stern	Minneapolis	Non-voter		
		Hoening	Kansas City	Non-voter		
↓	{	Fisher	Dallas	Non-voter		
		Duke	Board member	Voter		
		Pianalto	Cleveland	Non-voter		
		Warsh	Board member	Voter		
		Tarullo	Board member	Voter		
		Lockhart	Atlanta	Voter		
		Kroszner	Board member	Voter		
		Bernanke	Chairman	Voter		
		Dudley	New York	Voter		
		Bullard	St. Louis	Non-voter		
		Fisher	Dallas	Non-voter		
		Kohn	Board member	Voter		
		↓	{	Evans	Chicago Fed	Voter

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### **First date of publication**

Please see the front page of this research report.

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