CAPITAL MARKETS RESEARCH

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Special Report:
June Fed Statement Expectations

- **A materially more dovish Fed is in the bag, but is it trigger-time for our longstanding call for more stimulus by mid-year?**

At a minimum, tomorrow's FOMC statement (12:30pm ET) which follows the two-day meeting that started today will take a substantially more dovish tone. That will start by revising growth and inflation expectations lower within the accompanying Staff Economic Projections (2pm ET) which will be elaborated upon during Chairman Bernanke's press conference (2:15pm ET). Table 1 tracks the April staff projections. Oil and gas prices were thought to be temporary influences on inflation in April as base effects waned, but their significant declines since then have put inflation forecasts under further downward pressure so much so as to leave the Fed's price stability mandate under renewed pressure of under-performing the Fed's inflation target. The Fed will also have to change its tune about labour markets, no longer being able to cite recent improvements such that the full-employment half of its dual mandate is also under pressure. The statement will also likely signal more concern about geopolitical risks, compared to earlier in the Spring when markets had a more buoyant post-ECB LTRO bias. The Fed will also need to signal very clearly its intent to provide insurance if needed through more stimulus. One additional possibility is whether Richmond Fed President Jeffrey Lacker drops his dissenting vote against holding the fed funds target steady through to at least the end of 2014 although this is also contingent upon other steps that may be taken within the statement. The last page of this report provides the statement text from the April 24-25th FOMC meeting and highlights several elements of the text that are areas that we think pose statement vulnerabilities tomorrow.

If the FOMC statement contains only softer words, however, then it's quite likely that the risk trade won't like what it gets. To this effect, we also comment on what we think are possible forms of additional stimulus starting with the easier options.

Table 1

Fed: Staff Economic Projections & Outcomes

	Change in Real GDP	Unemployment Rate	PCE Inflation	Core PCE Inflation
January Projection	2.2% - 2.7%	8.2%-8.5%	1.9%-2%	1.5% - 1.8%
April Projection	2.4% - 2.9%	7.8-8.2%	1.4%-2%	1.8% -2%
Q1 2012 Actual*	1.90%	8.26%	2.26%	1.93%
2012 YTD*	1.90%	8.22%	2.15%	1.93%
Most Recent	*Q1 2012: 1.9%*	*May 2012: 8.2%*	*April 2012: 1.8%*	*April 2012: 1.9%*

Source: Scotia Economics, Fed, BLS, BEA
* Average level (except for GDP)

1. The Fed may push out target rate guidance beyond the end of 2014. If they do so, then anything less than a six-month extension would be entirely pointless. Even at that, this likely won't have an effect because markets are largely already convinced of a prolonged pause, and because the track records of other central banks that provide rate guidance like the Reserve Bank of New Zealand and Sweden's Riksbank are so poor that markets won't attach much significance to a longer period of rate guidance anyway.

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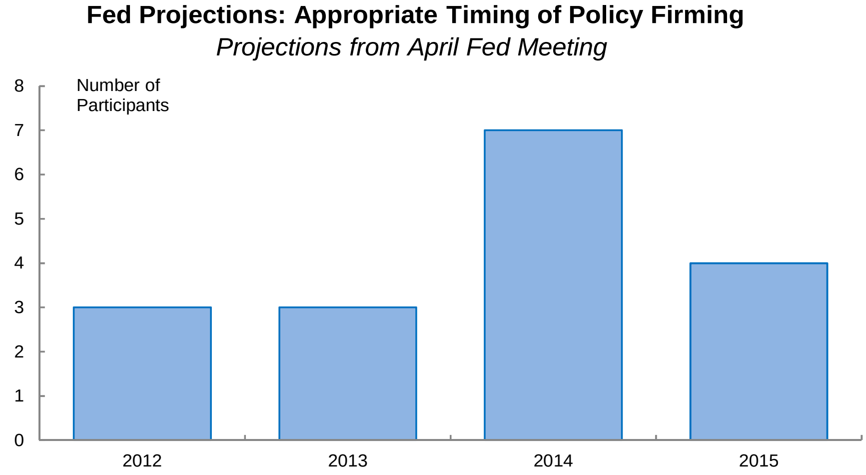
Chart 1



Source: Scotia Economics, Fed

2. Within the composition of forecasts (chart 1) you may see fewer suggesting to bring forward rate guidance and with the aforementioned risk that Lacker doesn't dissent again. This may or may not coincide with pushing out the median target guidance.
3. They could easily extend the twist but, since the Fed doesn't have many short maturity securities left, this would be an extension of under half of the original twist that was about US$400B and thus fairly small. To have a bigger effect they'd have to push the selling beyond 3 years and sell 4 years or further in order to buy the belly and long end which would give less of a duration impact than when they did the twist the first time but that could result in a program of comparable size to the original contemporary version. Overall, since operation twist had no lasting effect on markets or the economy, and because it was very controversial with some asset managers like pensions and longer-tailed insurers, we think markets could be disappointed by the pursuit of this option and the effect would sharply differ by market (e.g., Insurers' share prices relative long-end Treasuries).
4. Another option is to cut the interest on excess reserves which would help dealer carry somewhat, but not much else. We attach fairly low odds to this option.
5. Nominal GDP targeting is another remote possibility, but an unlikely one at this juncture as it's not clear that enough communication effort has been put into assisting markets with how to interpret such a step.

In all, so far these are fairly milquetoast policy options in our opinion. If the Fed wishes to truly take out additional insurance against downside risks as Vice-Chair Janet Yellen put it, then additional asset purchases via a third round of non-sterilized quantitative easing would seem to be the boldest option. Such a step is perhaps less likely to encounter criticism from emerging markets in particular as their own growth wanes in cases like China, India and Brazil, and as they pursue their own easing steps. In addition, with inflation waning the Fed is under less pressure to perhaps sterilize some or all of its purchases. We would give non-sterilized QE3 significant 40-50% odds of appearing tomorrow, but with our base case remaining somewhat in favour of QE3 in Q3. If the Fed extends Operation Twist again then this would come at the expense of QE3 over the duration of 2012.

One reason for holding off on QE3 or even a large twist extension just now (although it's a close call) is that the Fed has typically waited to react to soft spots in markets and the economy in QE1, QE2, the twist, and the USD swap funding arrangement. Acting now would be a shorter response time for a Fed that likes to take its time to see if weakness will persist. Perhaps the data is temporarily fouled up with distorted seasonal adjustments, or maybe enough risk has been taken off the table this Spring to merit somewhat more stable markets, or maybe the Fed will want to wait until after the EU Summit. Also, the Fed will get a bigger market effect upon rolling out QE3 when markets are being hit harder than at present, or through the possibility of a globally coordinated step or series of steps. Arguing against this would be Yellen's comment from the #2 office that she is already convinced of the need to take out more insurance against downside risks. Thus, the timing makes this a very tricky call.

If the Fed undertakes QE3, then we think they go big but keep their options open in terms of the way in which such a program is tailored. For instance, the Fed could introduce at least $400-500B in purchases but with a one year or longer implementation period that retains the right to cut it off (or drag it out) as they see fit. They could tinker with the average pace of monthly purchases and communicate that the Fed will tailor that to what they see as being required as time evolves. To us, this approach has merit and could give the Fed a lot of flexibility in addition to appealing to the more moderate and centrist votes.

Throughout the debate, Scotia was among the small minority of shops to expect a return to providing more Fed stimulus by about mid-year and into 2012H2 and to stick consistently to it compared to more bullish views on the economy and markets since the start of the year. We felt that US growth would disappoint again in 2012, that inflation would ebb, and that geopolitical risks would remain high in our January piece "Fed's Published Rate Forecasts Could Be A Warm-Up To QE3." That view was updated in our piece "Reasons Why Additional Fed Stimulus Remains On The Table" on April 27th, and our views against politics being a barrier to further action were summarized in "Would The Fed Be Captive To The Electoral Cycle?" on May 11th. Today the main issues are about the exact timing and form of additional stimulus, but the very fact that markets are back to seriously considering this debate is instructive insofar as our 2012 bias is concerned. On balance, our view is that if the Fed does not embrace a large stimulus program tomorrow (expectations for which have aided the risk trade lately) and if the next EU Summit disappoints again, then the risk trade could well be disappointed enough in order to tee-up QE3 in Q3. The meeting dates for the rest of the year are July 31-August 1, September 12-13, October 23-24, and December 11-12.

Appendix: Vulnerabilities Within FOMC Statement From April 25th 2012

The following is the Statement text from the April 24-25, FOMC meeting. <u>The text in bold highlights several elements that we think pose statement vulnerabilities tomorrow.</u>

> "Information received since the Federal Open Market Committee met in March suggests **that the economy has been expanding moderately**. **Labor market conditions have improved in recent months**; the unemployment rate has declined but remains elevated. Household spending and business fixed investment have continued to advance. Despite some signs of improvement, the housing sector remains depressed**. Inflation has picked up somewhat, mainly reflecting higher prices of crude oil and gasoline. However, longer-term inflation expectations have remained stable**.
>
> Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects economic growth to remain moderate over coming quarters and then to pick up gradually. Consequently, the Committee anticipates that the unemployment rate will decline gradually toward levels that it judges to be consistent with its dual mandate. Strains in global financial markets continue to pose significant downside risks to the economic outlook. **The increase in oil and gasoline prices earlier this year is expected to affect inflation only temporarily, and the Committee anticipates that subsequently inflation** will run at or below the rate that it judges most consistent with its dual mandate.
>
> To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee expects to maintain a highly accommodative stance for monetary policy. In particular, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run**--are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.**
>
> **The Committee also decided to continue its program to extend the average maturity of its holdings of securities as announced in September. The Committee is maintaining its existing policies of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate to promote a stronger economic recovery in a context of price stability.**
>
> Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Dennis P. Lockhart; Sandra Pianalto; Sarah Bloom Raskin; Daniel K. Tarullo; John C. Williams; and Janet L. Yellen. Voting against the action was Jeffrey M. Lacker, who does not anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate through late 2014."