

Cyprus rejects bailout, ECB to meet

Market action

Asian equity markets were mixed after the Cypriot Parliament rejected a tax on bank deposits that would partially fund a bailout for the country. However, policy makers continue to consider other bailout packages that would keep Cyprus in the Euro Area. In an attempt to calm markets, the European Central Bank reaffirmed "its commitment to provide liquidity as needed within the existing rules."

Looking at individual markets, the Nikkei surged 2.0%, the Hang Seng jumped 1.0%, and the Shanghai Composite skyrocketed 2.7%. Meanwhile, the Korean Kospi fell 1.0%, and the Indian Sensex slid 0.7%.

In Europe, stocks are up 0.2% in the aggregate. The region's blue chips are outperforming the broader aggregate, trading 0.6% higher. Back at home, S&P futures are pointing to a strong open, up 0.3%.

In the bond market, Treasuries are selling off across the curve, as the 10-year and 30-year yields have increased 3bp, to 1.93%, and 2bp, to 3.15%, respectively. In Europe, UK gilts are up 6bp, to 1.88%, German bunds are up 3bp, to 1.37%, and Spanish 10-year yields are down 4bp, to 4.98%.

The dollar is weakening against a basket of other major currencies, with the DXY index down 0.2%. In the commodities market, WTI crude oil prices are up 72 cents, to \$92.88 a barrel. Gold prices are down \$1.75, to \$1,611.00 an ounce.



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Overseas data wrap-up

United Kingdom: As expected, the ILO unemployment rate 3-month moving average was unchanged in January, at 7.8%. The number of employed increased by 131,000 in the 3-month period ending January, slightly below the consensus forecast of 140,000. In the same period, average weekly earnings slowed to 1.2% yoy from 1.3%, undercutting expectations of a pickup to 1.5%.

Today's events

Data deck for 20 March

Date	Time	Indicator	Period	BofAML Estimate	Consensus	Previous
3/20/13	14:00	FOMC Rate Decision	–	0.25%	0.25%	0.25%

Source: Bloomberg, BofA Merrill Lynch Global Research

FOMC preview

Two-handed Fed outlook

President Truman famously called for a one-handed economist, so he would not have to hear, “on the other hand...” So it may be at the March FOMC meeting with regard to the labor market — the key to both QE and forward guidance. On the one hand, the recent US employment data have been stronger. On the other, the sequester is likely to result in significant job loss. On the one hand, the FOMC’s unemployment-rate projections are likely to be revised down. On the other, the labor market remains a long way from “substantially improved.” The back-and-forth is likely to be broken by Chairman Bernanke’s press conference, where we expect him to decisively come down on the side of an extended QE program. This should reduce concerns around the exit process. The Fed will also likely ratify market expectations of the first hike (priced for mid-2015).

The upside

The FOMC will release its statement at 2pm on Wednesday, along with an updated Summary of Economic Projections (SEP). In January, the Fed noted a temporary pause in 4Q12 growth; the more recent data suggest a rebound in activity for January and February. We expect that the statement will acknowledge the better momentum. With the unemployment rate down to 7.7% in February — which is at the upper-end of the current central tendency for the end of 2013 — we look for the unemployment-rate projections to be revised down for both this year and the next.

The downside

On the other hand, the long list of downside risks that Fed officials have mentioned in the minutes — Europe and China, fiscal austerity, uncertainty — has only worsened since the last FOMC meeting. The Italian elections and Cyprus bailout have brought European woes back to the front page. Chinese data have softened recently. And the sequester, which many Fed officials hoped would be averted, instead looks likely to hit with full force. We expect that will be a strong headwind to job creation in 2Q13, perhaps resulting in as many as 500,000 jobs being lost over the course of the year.

Bernanke breaks the tie

As a result of this mixed picture, we expect the dispersion of FOMC growth forecasts, which has already started to widen again, to expand further in March. On net, however, we still expect the Fed’s growth forecasts to remain above consensus. So, are the changes to the SEP on net hawkish?

We do not think so, and expect Bernanke to sound rather dovish in his post-FOMC press conference at 2:30pm on Wednesday. He is likely to reiterate his view that the benefits of QE outweigh the costs, and that the cost of ending QE too quickly would also be significant. He is also likely to argue that the Fed needs to keep policy accommodative for quite some time, in order to see a “substantial” improvement in labor-market conditions. For example, despite the fairly steady improvement in the unemployment rate since the recession ended, the employment-to-population ratio has barely budged. In other words, the reduction in the unemployment rate has been driven largely by people exiting the labor force — giving up looking for work — which is not a desirable outcome in the mind of Bernanke and many of his FOMC colleagues.

Thus, we expect Bernanke to push back against questions that suggest a relatively early end to QE3. Despite the December and January minutes highlighting that “some” to “several” FOMC participants expected to end asset purchases this year, we expect Bernanke’s comments at the press conference to suggest that QE3 is likely to extend through the year-end, at least. One way to clarify just where the Committee sits in terms of the outlook for QE: to include member’s views on the likely path of the balance sheet over time, just as they do now for the likely path for the federal funds rate. That would help anchor market expectations of when QE3 might be cut back or concluded. While that addition to the SEP is not a guarantee for this meeting, we see a significant chance that it will happen sometime this year.

Rate-market implications

The rate-market implications will depend on its perception of the Fed’s commitment to its two-pronged easing approach – forward guidance and QE3. With the recent flight to quality decline in rates, the market is now pricing the first Fed hike in mid-2015, which is reasonable, in our opinion. As for QE3, our model (using the spread between inflation breakevens and real rates) estimates five more months of buying at the same pace, or a longer period with some tapering of purchases at the end. We expect the market to extend this timing, primarily if economic data weakens. However, the steepness of the curve and richness of the payer skew in the options market indicate that the market is concerned about a substantial rise in rates as we approach the end of QE3 and the exit. If the Chairman reduces some of this risk during the press conference, Treasuries should do well at the margin, especially in the belly of the curve, in our view.

To read the full report: [Liquid Insight, 19 March 2013](#).

In the news

Home healing

According to the Wall Street Journal Online article, “More Homeowners Dig Out,” rising home prices are translating into fewer households underwater, a positive sign for the economy. As reported by CoreLogic, the percent of households with a mortgage that was underwater fell to 21.5% in 2012 from 25.2% in 2011. The article mentions that increasing household wealth should also lead to greater consumer spending and improving sentiment. However, we believe that this wealth effect may be muted, particularly for lower-income households.

As we mentioned in our most [recent weekly](#), upper-income households are the main driver of spending today. Meanwhile, lower-income households are the main driver of spending volatility and face many challenges. Specifically, they struggle with low wage growth and little access to wealth appreciation – they own a very small share of financial wealth, and tight lending standards make it difficult to realize increased home equity. Furthermore, the payroll tax hike will continue to weigh heavily on these households, leading to decreased spending and declining sentiment. Thus, while increasing home prices are certainly a piece of the puzzle, we are still far from a healthy and sustainable broad-based consumer recovery.

Data recap

Housing starts in line with expectations

Housing starts rose to 917,000 saar in February, in line with expectations of 915,000. January data were revised upward to 910,000 from 890,000 and December data were revised up to 982,000 from 973,000. Due to the strong revisions, the data pushed up our 1Q GDP tracking estimate by 0.1pp to 3.1% qoq saar. Also, our 1Q residential investment tracking estimate is now 17.5%.

Looking at the details, single-family starts increased 0.5% mom, to 618,000 saar, and multi-family starts jumped 1.4%, to 299,000. Building permits surged 4.6% mom, up to 946,000, beating expectations of 925,000. Meanwhile, the number of homes under construction climbed 2.3% mom, to 575,000.

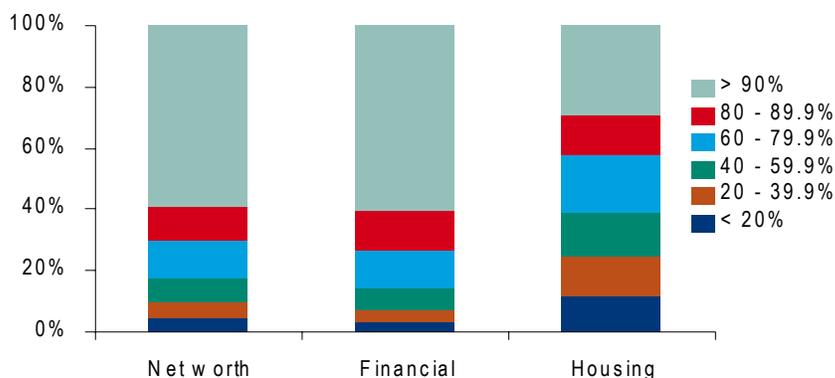
We continue to expect strong housing starts throughout this year as pent-up demand and low inventory in the real estate market facilitates greater investment and construction activity. Specifically, we forecast starts increasing to 990,000 in 2013 from 781,000 in 2012.

Charts of the day

Distribution of wealth by income cohort

The individuals who earn the most income are the ones with the greatest net worth. The top 10% of earners holds 59.0% of net worth. This is concentrated in financial assets, since 68% of total wealth is comprised of financials. Outside of retirement accounts, such as 401K plans or pension funds, lower-income households have little exposure to the stock market. In contrast, housing wealth is more evenly distributed with the top 10% of the income cohort holding 29% of housing wealth.

Chart 1: Distribution of wealth by income cohort (% share of asset)



Source: BofA Merrill Lynch Global Research, FRB Survey of Consumer Finances 2010

Link to Definitions

Macro

Click [here](#) for definitions of commonly used terms.

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