FOMC preview: Tinkering with QE to provide a dovish message

- **Even as there has been some progress with regards to the vaccine, we expect the FOMC to reiterate that US monetary policy will remain accommodative for a considerable period of time**
- **While we expect status quo on policy rates and the size of the QE program, we see some important tweaks that could send dovish signals to the market**
- **We expect: (a) a lengthening in the maturity profile of the QE purchases program and (b) linking of the QE program to an outcome based forward guidance**
- **The outcome-based forward guidance on policy rates is likely to be left unchanged**
- **We also see upward revision to GDP projections for 2020, downward revisions to unemployment rate forecasts for 2020-23 and inflation projections to be left unchanged**
- **The 'dot plot' will continue to signal that the zero lower bound will remain firmly in place over the forecast horizon up to 2023, although a few additional members could vote for a rate hike in 2023 but that will have a limited impact on the market**
- **The FOMC outcome should yet again reinforce global reflation trades but the 'Brexit' outcome will drive near-term momentum in the DXY. USD/EM are likely to continue to trend with a downside bias**
- **While some flattening bias in US yield curve cannot be ruled out in the near-term, we do not expect this trend to sustain in the medium-term. Global reflation trades should remain in place over 2021 resulting in a steepening bias over the course of the year**

A conflicting macroeconomic backdrop: The FOMC is likely to face conflicting factors on the state of the economy. On the one hand, economic activity has fallen in Q42020 and is expected to remain weak in Q12021 reflecting a pick-up in second wave of infection and social restriction measures that are expected to remain in place. US labour markets have shown a very sharp deterioration in Q42020 and the momentum of pace of growth has moderated from the levels that were seen in Q32020. High frequency indicators such as PMI surveys, personal spending, retail sales and industrial production have shown a moderation in sequential momentum.

At the same time, progress on fiscal policy has remained limited, even as US Congress is negotiating to move forward with a new round of stimulus.

The only encouraging aspect has been progress with regards to the vaccine that would suggest a more favourable medium-term outlook. Despite the progress over the vaccine that could with a lag help in creating herd immunity in H22021 in the US economy, we still expect the underlying message to remain dovish and cautious about economic prospects.

Summarizing our expectations: Given the balance of risks, we expect the following:

- **QE Purchases: We expect the FOMC to increase its weighted average profile of its QE purchases** implying a reduction in purchases of shorter duration assets accompanied by an increase in longer-duration assets. This should not be confused with operation twist given that the Fed will not be selling shorter-end securities but instead will be purchasing more longer-end. It is also not an explicit yield curve control program given that the central bank will not be targeting a particular yield level.

- **Forward guidance:** We expect the FOMC to maintain its forward guidance on policy rates indicating that they will remain at the zero lower bound until there is credible progress on achieving their respective economic outcomes on inflation and the labour market. **In addition to the guidance on policy rates, we expect the FOMC to link its outcome-based guidance to the QE program to provide an assurance to investors that balance sheet expansion will continue to remain in place for a considerable period of time.**

- **Economic projections:** We think that there could be a mild upward revision made to GDP projections for 2020 reflecting a stronger than expected Q32020. Downward revisions are expected to be made to the unemployment rate for 2020-2023 while inflation projections are likely to be kept unchanged over the forecast horizon. **On the dot plot, we expect a few more members to move towards voting for a rate hike in 2023 but it is unlikely to be adequate to shift the median projections.** In the September policy meeting that was the last time the dot plot was introduced, there were 4 members of the 17 member (voting and non-voting) FOMC that penciled in a rate hike in 2023.

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- **Press conference/tone:** Overall, we expect a fairly dovish tone. The policy statement is likely to acknowledge the weakening in economic activity that has taken place in the near-term. We expect a continued emphasis on the need for more fiscal support in the Fed Chair's press conference. While there could be some optimism expressed about the medium-term outlook given progress on the vaccines for COVID-19, we still expect the Fed Chair to emphasize some degree of caution about the outlook. Herd immunity will take time as the vaccination of the US population gathers pace in 2021 that will in all likelihood force the central bank to provide a fairly dovish tone.

Market implications: Global reflation trades still remain firmly in place driven by progress with regards to the vaccine and continued assurances from global central banks that global monetary policy will remain accommodative. The ECB eased policy in line with expectations that helped in supporting the risk environment. The FOMC outcome could work as another positive catalyst with investors likely to respond favourably to the forward guidance provided on quantitative easing.

However, we reiterate that 'Brexit' will work as an important near-term driver of price action. Media reports indicate that some favourable progress has been made between EU and UK policymakers that will in turn work to drive price action in the near-term. We maintain our fairly wide trading range of 90.00-94.00 for the DXY in the near-term that takes in to consideration a variety of 'Brexit' outcomes. A favourable 'Brexit' outcome could reinforce more downside bias in the DXY. USD/EM could continue trading with a downside bias reflecting global reflation trades.

We would not rule out some near-term flattening bias in the US yield curve if as we expect the Fed to move forward with lengthening the maturity profile of its QE purchases. The lack of fiscal progress will also work to restrain upside in longer-end yields in the near-term. We maintain our near-term trading range of 0.7% to 1.00% for the US 10-year treasury yield. However, we see a steepening bias going in to 2021 driven by overall reflation trades in the global markets.

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