# FOMC preview: Setting the context for 2021

- **At the conclusion of its policy meeting later today, we expect the FOMC to maintain status quo with some acknowledgement of the fact that the recovery is faltering**
- **However, we expect the Fed Chair to emphasize that the medium-term outlook remains constructive from the prospect of a vaccine roll-out throughout 2021 and further fiscal support that is expected to be provided under a 'Biden' administration**
- **We also expect the Fed Chair to play down the prospect of 'tapering of QE purchases' as well as emphasize the need for continued monetary accommodation to fight off the pandemic over 2021**
- **Markets already appear to be positioning for a dovish outcome that is reflected in the fall in US longer-end yields over the last week. We maintain our call for consolidation in the near-term**
- **However, we think that the next big driver for US fixed income markets will be on news of the passage and quantum of fiscal stimulus that is being proposed by the Biden administration**
- **Although we expect the USD to trade flat in the near-term as investors wait for more clarity on the pace of the recovery, record low US real yields is likely to limit any upside potential. DM FX could trade flat against the USD but EM FX could strengthen further reflecting a favourable global liquidity environment**

**A review of the macroeconomic landscape:** Since the last policy meeting in December, there appears to be more broad-based signs that economic activity has weakened further in response to a pick-up in infections. Service sector activity in particular appears to have taken a substantial hit. Payrolls contracted for the first time in December since the height of the pandemic in April. Retail sales have also moderated. **While the recovery appears to be faltering in the near-term, optimism about the medium-term growth outlook has increased.** The distribution of the vaccine under the 'Biden administration' is expected to pick-up while another substantial fiscal stimulus is on the offing. Hence, the FOMC has to play a delicate balancing act in communicating to the market that policy will remain accommodative for a considerable period of time, even as some favourable developments have emerged from a medium-term perspective.

**What we expect from this policy meeting?: We expect that investors will use this policy meeting, particularly the press conference, to assess the Fed's approach if the constructive medium-term outlook does materialize.** Hence, investors will focus on the messaging that the central bank provides to investors. In this regard, we view this round of the FOMC policy meeting as fairly important in communicating its monetary policy response to possible developments in 2021.

We expect the following:

- **Acknowledging near-term weakness but constructive for the medium-term:** We expect the FOMC to make changes to its post policy statement to reflect the softening in growth momentum that has taken place over Q42020 and that is expected to persist in to Q12021. However, the assessment for the medium-term is expected to be kept unchanged with the Fed Chair reinforcing the fact that growth momentum could pick-up as the vaccine distribution helps in improving mobility and in that process economic activity. However, we expect the central bank to maintain that the risks to the outlook remains to the downside given the continued rise in infections.

- **Status quo:** Given that the FOMC has only just linked the size of its monthly QE program to achieving its economic outcome on employment and inflation in the December policy meeting, we do not anticipate any substantial changes to be made in this round. We expect policy rates to be kept unchanged and the monthly QE purchases of USD 120 bn to maintained. No changes are expected either on the forward guidance with the FOMC emphasizing its 'average inflation targeting regime'.

- **Fed's assessment on fiscal policy:** Another important question for investors will be how the central bank views the proposed fiscal stimulus program of the US government. Specifically, questions will arise on whether there will be any changes that the Fed might consider to its framework in the medium-term if the Biden administration moves forward with its USD 1.9 tn fiscal spending program. We think that the FOMC Chair will indicate that increased government support will remain an essential part of the recovery that the central bank has already assumed and that at this stage no major changes are being considered within the committee.

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- **No tapering of asset purchases to be considered as yet:** Over the last month, debate on the market has increased about the prospect of the Fed considering tapering of its asset purchases program if the quantum of fiscal policy measures does go through. However, the Fed Chair and some of the voting members including Clarida and Brainard have played down such a possibility. A similar message was also provided by the Fed Chair in which he indicated that it is still premature to consider such an option of tapering asset purchases. He said that 'we will communicate very clearly to the public and we will do so well in advance before actively considering any tapering of asset purchases'. **Our working assumption is that the FOMC maintains the size of its asset purchases program over 2021 and any tapering could take place in 2022.**

- **Medium-term policy options could be discussed:** We think that at some point the FOMC will have to consider options such as lengthening the maturity profile of its asset purchases program at a later date possibly from H22021 onwards or a possible yield curve control program to supress yields at the longer-end of the curve at a later date possibly in 2022. We think that there could be some mention of such programs during the press conference.

**In short, we expect the FOMC to maintain status quo but provide a dovish message to reinforce the fact that monetary policy needs to remain accommodative to continue to fight off the pandemic.** In this round of the policy meeting, the FOMC is not scheduled to update its economic projections. There is also likely to be the annual rotation of voting members in the committee that will take place. The shift that is due to take place will likely lend to imply a more dovish outlook within the voting FOMC members as Charles Evans (dove), Thomas Barkin (centrist), Raphael Bostic (centrist), Mary Daly (centrist) and Christopher Walker (dove) who is due to fill in the Board of Governors position replace Loretta Mester (hawk), Patrick Harker (centrist), Robert Kaplan (centrist) and Neel Kashkari (dove).

**Market response:** US bond markets already appear to be positioning for a dovish outcome that is visible in the sharp fall seen in the US yields at the longer-end of the curve over the last week with UST 10 year sovereign yield falling by 5 bps. We do not anticipate a substantial response in the market from the outcome. However, **the FOMC Chair reinforcing a need for an accommodative framework as well as playing down the prospect of tapering of purchases could work to: (a) cap any sharp upside emerging in yields in the near-term and (b) keep risk sentiment supported.**

We maintain that range trading could persist with the UST 10 year yield likely to trade in the 1.00%-1.20% range with the next big trigger likely to come from the outcome of the 'fiscal negotiations' in Congress. The passage of a 'Biden stimulus' could work to drive more upside in yields at the longer-end.

**We think that the USD will continue to trade range bound in Q12021 but sharp upside is unlikely as US real yields are likely to remain at a record low.** Besides, investors are still waiting to assess the full-effects of the new variants of the virus and the pace of vaccine distribution before fresh positions can be taken. We maintain our call of the DXY trading in the 89.50-91.50 range in Q12021 with USD/EM trending with a downside bias reflecting a fairly favourable 'global liquidity' environment.

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