FOMC preview: Upgrading its forecasts but not changing its message

- **The FOMC has a difficult task at the conclusion of its meeting later today. It has to on the one hand raise its economic projections but on the other hand communicate that its policy framework is unchanged**
- **We think that the FOMC will maintain status quo emphasize that the US economy is still on the mend that warrants an accommodative framework, even as the medium-term outlook remains very constructive. It will use the fact that it is still some distance away from meeting its objectives of 'maximum employment' and 'an inflation overshot above 2% for some time' to justify the need for continued accommodation to remain in place for a considerable period of time**
- **Markets will also use the economic projections/dot plot provided to assess the Fed's reaction function to the new fiscal stimulus program that has been delivered**
- **We see US economy growing by 6.5% YoY in 2021 driven by increased fiscal support, step-up in vaccination drive and sharp pick-up in pent-up demand. We see upside risks to these projections. Hence, we expect the FOMC to raise its GDP projections for 2021-2022**
- **On the labour market, we think that the FOMC will lower its unemployment rate forecasts over 2021-23 reflecting expectations of a robust pick-up in service sector activity**
- **On inflation, we see a mild upgrade with a possible overshoot of 2% likely to be forecasted for 2023. The FOMC Chair could emphasize that inflation could overshoot on a temporary basis in 2021 but will remain focused on assessing whether there is a generalized increase in prices particularly services inflation**
- **On the dot plot, we think that the median will continue to emphasize that policy rates will remain on hold over 2021-23. However, we see an increase in the number of members voting for rate hikes in 2022 and 2023, even as it will not affect the median outcome**
- **We do not expect the FOMC Chair to express concerns about 'financial conditions' or about recent uptrend in longer-end bond yields**
- **We also forecast that the Fed will move towards tapering of its purchases in Q12022 but that will only get communicated by the central bank in Q42021**
- **In theory, the FOMC will try to sound as dovish as possible. However, global markets are positioning for a sharp US led recovery in the global economy that we think will remain in place in the medium-term irrespective of the message provided by the FOMC**
- **For bond markets, some consolidation is possible in the near-term but we see a further steepening bias over 2021 with UST 10 year likely to drift higher in the medium-term. Some response is also likely if a decision is made on the Supplementary Leverage Ratio (SLR)**
- **For the USD, some consolidation cannot be ruled out in the near-term with EM FX and commodity FX rallying by a minor degree. However, we see broad-based upside potential in the USD in the medium-term**

We upgrade our outlook on the US economy: Since the last policy meeting in January and the last time that the FOMC reviewed its economic projections in December, two important developments have taken place that it will have to account for.

- First, there have been two sizeable fiscal stimulus packages—USD 900 bn (4.2% of GDP) that had passed late in December and USD 1.9 tn (~9% of GDP) that was just passed in March-2021.

- Second, pace of vaccination has picked up with the US FDA providing clearance to –Pfizer/BioNtech, Moderna and Johnson & Johnson vaccines for emergency use respectively. Back in December, only one of the vaccines had received approval. The US president has indicated that by End-May there should be adequate vaccines to cover the entire adult population and that normalcy in US economic activity should resume by the summer.

Hence, we have upgraded our economic outlook on the US economy reflecting increased fiscal support, slowing in the pace of infections over the last month, sharp increase in personal savings and easing restrictions as more of the population receives the vaccine. We raise our US GDP projections from 4.8% YoY to 6.5% YoY for 2021 from -3.5% YoY contraction in 2020. Risks to our projections remain to the upside given that the US government is proposing to introduce another infrastructure spending program later in the year and that there is the prospect of a much sharper rise in household spending than we are projecting. We also estimate that the US economy in terms of size of GDP will reach its pre-pandemic levels by Q22021.

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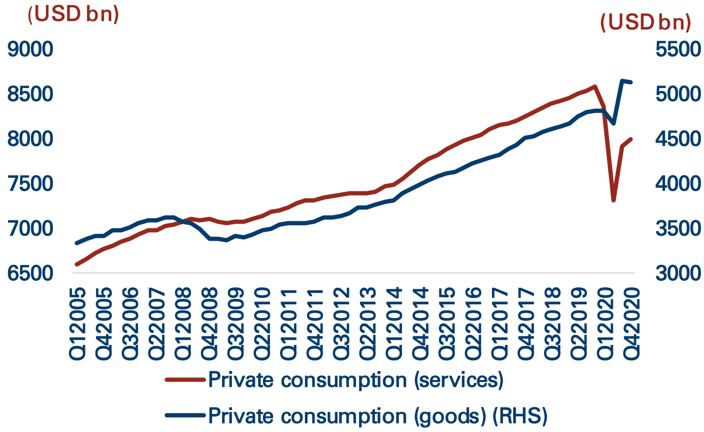
Taking the fiscal stimulus measures in to account: Key components of the fiscal stimulus measures that have been announced over 2020-21 have been in the form of direct cash transfers. We estimate that a cumulative sum of USD 880 bn has been provided via higher payments via unemployment benefits and USD 958 bn via direct transfers to households. **In total there has been close to 9% of GDP of direct cash transfers that has been cumulatively provided by the fiscal responses so far.**

A greater proportion of the cash provided has been saved by households reflecting precautionary motives as uncertainty about the economic outlook has persisted and because of compromised mobility that has restrained households from spending. Prior to COVID-19, personal savings stood at USD 1.27 tn (7.6% of disposable income) and that has now risen to USD 3.9 tn (20.5% of disposable income) as of January-2021. These figures do not take in to account additional transfers that will be made from the fiscal stimulus bill that was passed in March-2021. **We think that savings in excess of pre-COVID-19 levels could be to the tune of USD 2.5 tn to USD 3 tn. Hence, there is substantial potential for a surge in spending as pent-up demand increases once restrictions are eased.** Fiscal funding has also been provided to state governments, child tax credit, rental home owner assistance and to healthcare sector that should also work as incremental contributors over 2021-22. **In short, the prospective boost from fiscal stimulus will be fairly sizeable.**

US spending on services will likely pick-up: While the boost to income levels will drive consumption higher, another key aspect of the US recovery has been a dichotomy in consumption spending on goods versus services. Private consumption on goods went above the pre-COVID-19 levels as early as Q32020 reflecting the Fed's monetary policy stance and the re-opening of the economy from the lockdowns. However, consumption on services that is the much larger component of overall private consumption has remained depressed as social distancing norms have been maintained. Going forward, we see an acceleration that is likely to take place in consumption of services as mobility picks up in H22021 while consumption of goods is likely to continue to remain fairly robust.

Chart 1: US private consumptions in services has not picked up as sharply as compared to goods

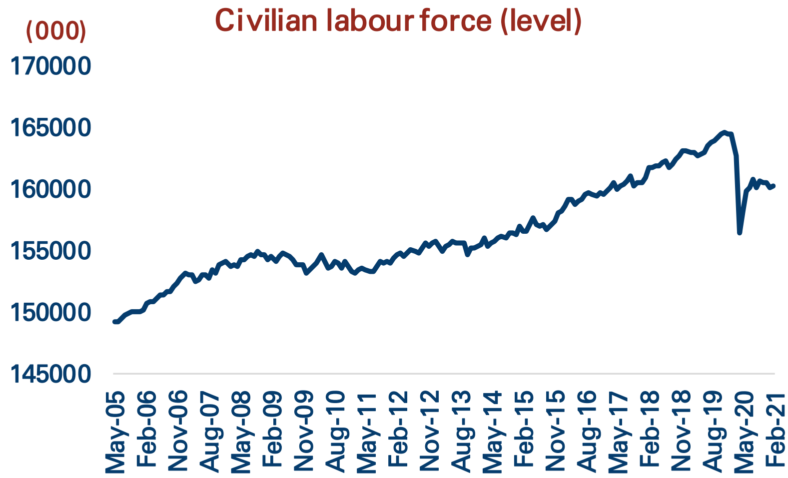


Note: Data is based on chained dollars (2012)
Source: US Bureau of Economic Analysis & ICICI Bank

US labour markets are on the mend but much more work is required: Payrolls surprised to the upside in February with the majority of the sequential improvement coming from employment in high contact services sector. However, we estimate that there is still close to 9.5 mn job losses since the pandemic, even after the fairly robust reading recorded in February. While the unemployment rate has drifted sharply lower from a peak of 14.7% in April-2020 to 6.2% in February-2021, much of the improvement has come on the back of people leaving the labour force. We find that there has been close to 4.3 mn people who have left the labour force from end-2019 levels to February-2021. The employment to population ratio was at 61.1% in end-2019 while it is currently at 57.6%. Considerable divergences also remain within age and ethnic groups.

The outlook remains constructive as service sector employment is expected to increase sharply over 2021. However, we expect people to re-enter the work-force that should stagger the pace of downtrend in the unemployment rate. It might take up to end-2022 or H12023, assuming a monthly payroll figures of around 400K-500K, before US labour markets get back to the pre-COVID-19 levels. If pace of monthly job gains is lower, then it could take some time longer for labour markets to record a full-recovery. In short, US labour markets will still need further time to fully recover. The sustainability of US growth after the effects of the fiscal stimulus fades will depend on the strength of the labour market that will be an important consideration for the FOMC in its decision making.

Chart 2: US labour force participation has fallen sharply over 2020



Source: US Bureau of Labour Statistics & ICICI Bank.

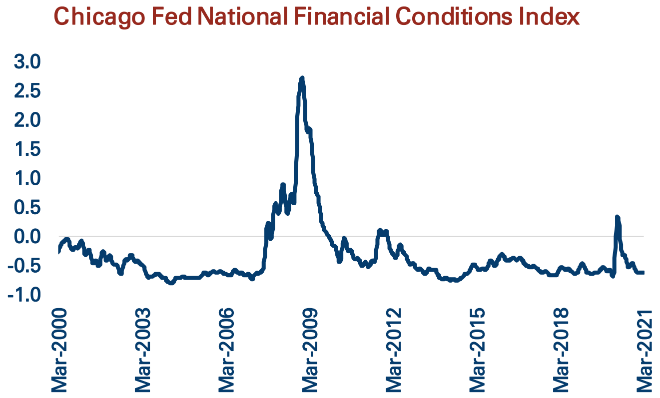
Inflation is going higher but will it be permanent or transitory?: US inflation pressures are likely to accelerate going over Q22021 to Q32021 driven by strong 'base-effects' reflecting sharp fall in commodity prices and as lockdowns kept economic activity depressed over the same time in 2020. We see US PCE overshooting to the 3.2% to 3.3% mark in Q2 before moving back to ~2% to 2.2% mark by end-2021.

We think that 'goods inflation' could accelerate over 2021 reflecting the rise in commodity prices that have taken place. However, several questions remain on the future trajectory of service sector inflation. Over the last decade, the US Phillips curve has flattened that kept inflation flat even as the US labour market moved in to full-employment threshold. Hence, the Fed will probably look through temporary overshoot and focus specifically on underlying inflation (service sector inflation in particular) to see if there is a more generalized increase in price pressures as output gaps (difference between actual and potential growth) turn positive by the end of 2021 after turning sharply negative over 2020. In the most recent reading in February-2021, core inflation came in lower than expected.

Rising inflationary expectations: A concern for the Fed?: Over the 2021, the re-pricing of the US macroeconomic landscape has resulted in a sharp rise in 'break-even' inflation rates. The US 10-year break-even inflation has risen by ~33 bps over 2021 to 2.29% at the time of writing from 1.97% as at end-2020 and from a low of 0.5% at the height of the pandemic in March-2020. It has now reached levels that were last seen back in 2014-15 but is not at record high levels. In this regard, an important point to consider is that the Fed as part of its mandate is targeting an inflation overshoot above the 2% mark for a period of time to make up for undershoots in inflation. The break-even inflation is derived from the difference between the US 10-year nominal yield and the 10 year TIPS value (real yields). The TIPS is deflated from CPI inflation, which on average tends to be about 30-40 bps higher than the Fed's preferred measure-- the PCE index. Hence, a 'break-even inflation' rate of 2.29% would mean that the Fed is just meeting its target. The new average inflation targeting regime implies that the Fed needs to target an overshoot for a period of time. **Hence, we suspect that the Fed would feel comfortable with 'break-even' inflation moving even higher to the 2.5% to 2.6% mark going forward to meet its new mandate.**

Are financial conditions tightening too quickly?: We think not. US financial conditions and global financial conditions are still remain fairly accommodative. US yields remain at record low levels, credit markets are functioning relatively well and equity markets are at record highs. The USD has appreciated but in trade-weighted terms is still well below the pre-COVID-19 levels. The rise seen in US yields, primarily real yields, is a reflection of an upward re-rating of US growth prospects that has taken place in response to the fiscal stimulus package delivered by the Biden administration. The upshot is that we do not expect the Fed concerns about overall financial conditions to surface at the current juncture.

Chart 3: US financial conditions remains accommodative



Note: Lower the level easier financial conditions are and vice-versa
Source: Federal Reserve & ICICI Bank.

FOMC: Our expectations: The Fed will have to play a delicate balancing act of taking in to account the improvement in the outlook while also communicating to the market that policy needs to remain accommodative in order for it achieve its economic objectives. Besides, the Fed cannot overlook the fact that the economy is still in the midst of a pandemic and is only just about recovering. The two aspects of the Fed's objectives need to be understood:

- The Fed is targeting maximum employment not the level of unemployment implying that it will look at the overall state of the labour market before taking any major decisions.
- It will want inflation to move to 2% and overshoot that mark for a period of time.

The policy approach for the Fed particularly on its inflation objectives implies that it has to be reactive rather than being pro-active. An important aspect of this policy meeting is that the market will also use the economic projections provided to assess the reaction function of the Fed especially considering the fiscal impulse that has been provided. We expect the following:

- **Status quo:** We expect the FOMC to keep policy rates unchanged and size of monthly QE purchases of USD 120 bn unchanged as well. Forward guidance will continue to be linked to realizing its economic objectives on both maximum employment and an inflation overshoot of above 2% for some time.

- **Post policy statement:** We expect the FOMC to make limited changes. However, there could be an upgrade to the outlook to reflect fiscal measures and increasing pace of vaccines.

- **Economic projections:** We see the Fed raising its GDP projections for 2021-22 but possibly lowering them for 2023 as the effects of fiscal measures dissipate and growth starts to return to trend level.

  We see unemployment rate projections being lowered over the forecast horizon reflecting a resurgence in service sector hiring from 5% that was provided in December for end-2021 to 4.4%-4.5% and to 3.8% for end-2022 and 3.2%-3.4% for end-2023.

  Inflation projections could be raised over the forecast horizon with a possible 2.1% to 2.2% forecast for end-2023 from 2% that was recorded in the December policy projections.

- **Dot plot:** Back in December-2020, the median of FOMC dots was for status quo over 2021-23 horizon. 4 of the 17 members voted for one rate hike in 2023 and one member voted for more than one rate hike in 2023 but that was not adequate to change the median of status quo over the forecast horizon. **With the revisions that are expected to be made on growth and inflation, we suspect that there could be two to possibly three more members who might vote for one rate hike in 2023 but that may not be adequate to change the median expectations of 18 members, including the addition of Christopher Waller who has joined the Board of Governors. There might also be some members who might vote for a rate hike in 2022 itself but that will again not change the median expectations.**

- **Post policy press conferences:** We think that the FOMC Chair tone will not be too different from what we have seen over the last month. **His main message will be that the outlook remains fairly favourable in the medium-term but the recovery is still at a fairly nascent stage requiring continued support.** He is likely to play down tapering of QE purchases anytime soon. Concerns about a persistent inflation overshoot is also likely to be downplayed. **We wait to see whether the FOMC Chair indicates that the central bank is considering resorting to an operation twist or yield curve control (YCC) program that we think could be considered if yields continue to drift higher at a much faster than expected pace. We do not expect the Fed Chair to express any explicit concerns about rising yields at the longer-end of the curve as long as the rise reflects 'economic expectations'.**

In short, the FOMC's main message will be that the policy framework will remain accommodative given that the economy is still some distance away from meeting its economic objectives. Labour market recovery is only just setting in and it is too early for the Fed to assess whether inflation will overshoot consistently above 2% mark once the 'base-effects' begin to wane a bit later in the year. **Once the full-effects of the vaccine and fiscal stimulus become visible in H22021, we think that the Fed will move towards a gradual tapering of its purchases in Q12022 that the committee will start preparing the market for such a move in Q42021. Rate hikes are still some distance away that we think are possible to kick-in from H22023 onwards.** The Fed will also want to wait for definitive signals that the pandemic is on the decline before it begins to ease out the exceptional policy support that it has provided.

Market impact: Dovish but not changing the landscape: With our expectations of the Fed re-affirming the need for accommodation, even as the outlook is constructive, in theory should be dovish for the markets. However, the medium-term drivers of a sharp pick-up in US growth prospects cannot be ignored and that is what will influence price action in the market.

US yields have been trending higher reflecting expectations of rate hikes getting priced in over 2022-2023. As we expect the FOMC to downplay a sharp rise in policy rates, we think some near-term downside in bond yields at the longer-end of the curve cannot be ruled out. **However, we do not expect a trend reversal setting in as investors position for a sharp recovery over 2021 accompanied by elevated paper supply.** Hence, we see UST 10 year trading in range of 1.4%-1.7% in H12021 followed by a higher range of 1.7%-1.9% in H22021.

For the bond market, another ancillary development will be the decision that the Federal Reserve will take on the supplementary leverage ratio (SLR). The SLR is a capital adequacy ratio that US banks must maintain and stipulates that banks must hold 3%-5% of total assets in this ratio depending on the size of the bank. Back in April-2020, US authorities—Fed, FDIC and OCC—took a decision to temporarily exclude holding US treasury securities and reserves kept at the Fed in bank's asset portfolio while calculating the ratio. The exemption was provided for a one-year period that expires on 31-March-2021. This exemption allowed banks to increase exposure in treasury securities without concerns about the effect on the SLR. If the exemption expires, it will force banks to reduce their demand for US treasury securities over the medium-term. However, it remains unclear as to whether a decision will be taken in this policy meeting. Nevertheless, it will have important implications for fixed income markets that needs to be monitored fairly carefully.

For FX markets, a dovish tone could result in some consolidation in the near-term in the DXY in the range of 90.50-93.50 over H12021. EM FX, including the INR, could rally could rally marginally as well in the near-term. **However, we see the USD rallying in the medium-term with the first-round strength likely to be concentrated against low yielding FX such as the EUR and JPY. We see support increasing for the USD on a trade-weighted basis in the medium-term reflecting a US led global recovery taking hold over the remainder of 2021 and possibly going in to H12022.**

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