FOMC review: Status quo with a dovish guidance

- **The FOMC maintained status quo on expected lines and provided enough assurances that the accommodative policy framework will remain in place. The Fed Chair continued to emphasize the flexible average inflation targeting framework of the central bank**
- **The FOMC also linked the outlook of the economy to 'pace of vaccinations' along with the manner in which the pandemic evolves. Our assessment is that the central bank is working with the assumption of a revival in economic growth prospects in H20221, although considerable uncertainty still remains in place at the current juncture**
- **Emphasis was also placed on disinflationary forces, subdued inflation pressures and that considerable slack in the labour market remains in place. The prospect of tapering of purchases was downplayed as was financial stability risks and asset price inflation concerns**
- **We believe that the FOMC is in auto-pilot mode with the current framework expected to remain in place over 2021**
- **For the markets, the outcome was largely priced in. Instead, risk aversion has returned reflecting increasing concerns about the economic outlook that has pushed US yields lower and the DXY higher. We see these trends persisting in the near-term, although US fiscal negotiations will work as the next big driver for the fixed income markets**
- **While attention has been on the FOMC, another important development has been growing indications of the ECB considering whether to use policy instrument such as a policy rate cut to temper currency appreciation. This has pulled the EUR/USD pair lower in the process as exchange rate appreciation is being viewed as a disinflationary force in the region. We are watching these developments very closely**
- **While DM FX could weaken against the USD in the near-term, we still maintain our constructive outlook on USD/EM given the very accommodative global monetary environment**

On expected lines: The outcome of the two day FOMC meeting (26-27-January-2021) was in line with our expectations. The central bank maintained status quo and provided strong signals that its accommodative framework will remain firmly in place for a considerable period of time. The forward guidance provided was left unchanged with both the policy rates and QE linked to FOMC meeting its economic objectives on inflation and labour markets. **The Fed Chair was also quick to emphasize that the forward guidance needs to be viewed as an 'outcome based' guidance. Hence, the prospect of a reversal anytime soon is unlikely as the central bank remains focused on targeting an overshoot of inflation above 2%. The Fed Chair also downplayed the prospect of tapering at the current juncture as 'premature' given that focus remains on fighting the pandemic.**

Near-term activity downgraded…: The central bank acknowledged the weakening in economic activity that has taken place by stating that the 'pace of recovery …has moderated in recent months…with weakness concentrated in sectors that are most adversely affected by the pandemic'.

…but medium-term outlook will be driven by progress on vaccination…: The Fed reiterated that the path of the economy will remain contingent on the virus but it also added that the recovery will also be driven by 'pace of vaccinations'. The pandemic was expected to continue to weigh on economic outlook and that it poses considerable risk to the economic outlook was maintained. However, the words that the pandemic will affect economic activity in the 'near-term' was removed and that downside risks to the outlook for 'the medium-term' was also respectively removed from the policy statement. **This would suggest that the Fed is linking the outlook on the economy to 'vaccinations'. A pick-up in economic activity is expected in H22021. We assume that the Fed subsequently sees the risks from the pandemic more as a near-term risk factor than something that needs to be emphasized for the medium-term, although the Fed Chair did reiterate that it is difficult to quantitatively model the effect of vaccines or vaccine penetration that will help in ensuring some normalcy in economic activity.**

…low inflation will keep policy accommodative: While some optimism was placed on the medium-term if the vaccine proves effective, an important message was provided on inflation prospects. **The Fed Chair explained that the central bank will not be moved by transitory factors that could drive inflation higher and will remain focussed on targeting an overshoot.** What must not be forgotten is the significant disinflationary forces that have remained in place over the last decade and that will play an important role in central bank decision making. There was no substantial mention either of the recent uptrend seen in market derived inflation expectations in the press conference or the policy statement.

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We also take note of the commentary that the Fed Chair provided on the state of the labour market. In the press conference, he spent a considerable period of time in explaining that slack remains firmly in place and that at this stage it is unclear as to how much permanent change has taken place.

Fiscal policy remains important: An important message provided by the FOMC Chair was on fiscal policy. He indicated that both fiscal and monetary policy have been important in supporting the recovery. He also emphasized that more fiscal support is perhaps warranted and required. However, he stopped short of commenting on the new fiscal proposals of the 'Biden administration'. He also made no comments on the Fed changing its course if more fiscal stimulus is provided. Besides, the risks from a substantial increase in public spending on driving inflation higher was downplayed.

Financial stability risks will be addressed by macro-prudential tools: In this round of the policy meeting, considerable time was spent during the press conference on the examining the Fed's assessment on 'financial stability' and 'asset price inflation'. However, concerns about elevated asset prices and asset price inflation were downplayed. The Fed Chair stated that movements in asset prices over the last month or so has not been driven by monetary policy but by fiscal policy developments and expectations of the vaccine roll-out. Nevertheless, the following were the main messages provided by the central bank: (a) the central bank uses a variety of indicators in assessing the state of financial conditions and financial stability, (b) the central bank would prefer to use macro-prudential tools rather than monetary policy to address any concerns or risks that might build up on this front and (c) it will work with other US regulatory authorities if required to address any imbalances that might get built-up from time to time.

Road ahead: Fed is on auto-pilot mode in 2021: We maintain our call of the Federal Reserve maintaining its accommodative framework over 2021 with the size of QE purchases remaining unchanged. There could be a move to lengthening the maturity profile of these purchases in H22021. The tapering of purchases could begin in 2022 contingent on a sustained vaccine driven recovery setting in place in H22021. In 2021, the focus for the FOMC will be on providing as much support to the recovery as possible.

Markets: Risk aversion intensified: We think that the FOMC outcome and guidance was largely priced in that ensured a limited market response. Instead, risk aversion has intensified reflecting concerns about near-term growth prospects, new variants of the virus along with apprehensions about the vaccine roll-out in several DM economies. The net result has been a broad-based USD rally against both DM and EM.

However, an important development in yesterday's trading session has been continued indications from ECB policymakers that they might be open to cut rates to limit currency appreciation. A stronger currency is being viewed as a substantial disinflationary force in the region. We wait to see whether the ECB will follow through with such an action that could in turn work as a game-changer altering the FX trading profile for the EUR/USD pair in particular.

In short, we maintain that some more upside in the DXY is possible while keeping our range of 89.50-91.50 in the near-term intact. A re-assessment of possible action by the ECB and intervention threats by the BoJ is likely to restrain sharp downside emerging in the DXY. While some degree of risk aversion could pull USD/EM higher in the near-term, we still remain constructive on EM FX given the extremely favourable global liquidity environment that is likely to remain in place.

As far as US fixed income markets are concerned, we see some downside potential in bond yields in the near-term as risk aversion has returned. However, the prospect of substantial fiscal stimulus package could work as an important upside driver in the medium-term. We would not rule out a temporary undershoot below the 1% mark for UST 10 year yield but maintain our medium-term range of 1.3%-1.5% by end-2021 with upside potential.

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