ICICI Bank Global Markets

FOMC review: keeping it steady

- **The FOMC maintained status quo on expected lines with a dovish guidance provided while the forward guidance was kept unchanged**
- **GDP growth projections were raised in line with expectations and unemployment rate profile was forecasted to be lower over 2021-23**
- **At the same time, inflation was forecasted to overshoot to 2.4% YoY in 2021 and remain around or above 2% over 2022-23. However, the rise in inflation for 2021 was deemed to be driven by temporary factors that will not significantly influence policy decision making**
- **Despite the upward revisions made to inflation, the dot plot was unchanged with the median indicating that policy rates will remain at current levels over 2021-23**
- **The FOMC Chair emphasized that the central bank is some distance away from reaching its economic objectives and that the monetary policy decision making will be 'outcome based' not 'forecast based'**
- **Our reading was that: (a) the FOMC appears to be focused on ensuring that there is a persistent inflation overshoot before committing to hiking rates and (b) the FOMC will look not only at the unemployment rate but also at a variety of labour market indicators to assess the extent of slack in the economy**
- **The Fed Chair also played down concerns about tightening in financial conditions and the possibility of moving to either an explicit or implicit yield curve control program**
- **We maintain that the Fed will keep the current framework in place as it needs to continue to support the recovery that is still at a fairly nascent stage. QE taper could commence in Q12022 that the Fed will start to prepare markets for in Q42021**
- **In the rates market, there has been a further steepening bias visible as shorter-end rates have moved lower reflecting the message provided in the 'dot plot'. However, focus is shifting to the outcome of the BoJ policy meeting that is due to conclude tomorrow morning (IST). A decision on the SLR is still awaited and could be released in a 'few days' time**
- **In the FX markets, we think that the USD is entering a period of consolidation but we do not see a trend reversal setting in. However, we retain our medium-term upside bias on the USD on a trade weighted basis as investors price in a US led global recovery**

FOMC outcome in line with expectations: The outcome of the FOMC meeting was in line with expectations. Policy rates, monthly QE purchases program of USD 120 bn and forward guidance were kept unchanged. The decision was unanimous with all 11 voting members of the FOMC voting in favour of policy actions and decisions made. At the same time, economic projections were revised higher to take in to account the effect of the fiscal stimulus provided as well as expectations of a sharp surge in pent-up demand. Guidance provided was dovish with the Fed maintaining that despite an improvement in the outlook, policy rates will remain at current levels till end-2023.

Some of the key takeaways were as follows:

- **Policy statement: Mild upgrade visible:** The FOMC made mild upgrades to the outlook reflecting improving data, fiscal stimulus and that pace of vaccinations. The outlook continued to remain conditioned on the manner in which the pandemic will pan-out.

- **Growth projections revised higher for 2021 but kept flat over 2022-23:** On expected lines, the FOMC raised its GDP projections from 4.2% YoY for 2021 to 6.5% YoY that was in line with our in-house forecasts as well. However, the FOMC sees the fiscal impulse fading over time and have subsequently only marginally revised projections higher for 2022 while lowering them for 2023. In the press conference, the FOMC Chair indicated that economic activity is expected to rebound sharply over the coming months particular in high-contact services sector.

- **Unemployment likely to be lower but Fed is focused on 'maximum employment':** As economic activity is expected to rebound at a faster pace, there were across the board lowering in projections that were made in the unemployment rate over 2021-23. However, the Fed Chair emphasized that considerable slack remains in place that is not captured completely by the unemployment rate and that the Fed will be monitoring a variety of variables in assessing the strength in the labour markets. In short, the Fed is still a considerable distance away from meeting its mandate of 'maximum employment'.

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Chart 1: FOMC revised its outlook on the US economy but not the policy rate trajectory

Median Fed macro-economic projections				
	2021	2022	2023	Long term
GDP (%YoY)				
Mar 2021	6.5	3.3	2.2	1.8
Dec 2020	4.2	3.2	2.4	1.8
Sep 2020	4.0	3.0	2.5	1.9
Unemployment Rate (%)				
Mar 2021	4.5	3.9	3.5	4.0
Dec 2020	5.0	4.2	3.7	4.1
Sep 2020	5.5	4.6	4.0	4.1
PCE inflation (%YoY)				
Mar 2021	2.4	2.0	2.1	2.0
Dec 2020	1.8	1.9	2	2.0
Sep 2020	1.7	1.8	2.0	2.0
Core PCE inflation (%YoY)				
Mar 2021	2.2	2.0	2.1	
Dec 2020	1.8	1.9	2.0	
Sep 2020	1.7	1.8	2.0	
Median Fed funds rate (%)				
Mar 2021	0.1	0.1	0.1	2.5
Dec 2020	0.1	0.1	0.1	2.5
Sep 2020	0.1	0.1	0.1	2.5

Source: Federal Reserve & ICICI Bank

- **Inflation forecasts raised:** Inflation projections were raised with the PCE index expected to overshoot to 2.4% mark in 2021 and core PCE expected to overshoot to 2.2% mark in 2021. However, much of this increase will reflect temporary factors such as 'base-effects' and supply bottlenecks as the economy re-opens. The Fed will not be influenced by temporary increases in inflation but will target a persistent overshoot as the Fed Chair explained that 'a transitory rise in inflation above 2% will not meet standards for raising rates'. In this regard, the core PCE index will remain at or slightly above the 2% mark over 2022-23 based on the forecasts provided by the FOMC.

- **Dot plot: Median shows status quo over 2021-23:** As expected there were 4 out of 18 members who voted for a rate hike in 2022 and 7 of the 18 members who voted for a rate hike in 2023 but that was not adequate to change the median expectations of no rate hike over the forecast horizon. The fact that there appears to be an increasing number of members voting for a rate hike implies that if momentum is sustained, the median is likely to gradually reflect a rate hike in 2023 but that messaging could come towards end-2021 not in H12021.

- **QE tapering not in the immediate horizon:** The FOMC Chair ruled out the possibility of tapering of purchases in immediate future. In the press conference, he also indicated that the central bank will communicate well in advance on when it plans to begin tapering purchases to prepare financial markets.

- **Financial conditions are accommodative:** The Fed Chair emphasized that financial conditions remain accommodative. He further stressed that the central bank does not exclusively look at the 10-year yield while assessing the state of financial conditions. Instead, a variety of variables are examined. His statements further reinforce expectations that the Fed will not worry too much about longer-end bond yields as long as it reflects a pricing in of an improvement in the economic outlook.

- **OT and yield curve control played down:** The Fed Chair also played down the possibility of the central bank resorting to a yield curve control program or operation twist. The current monetary policy framework was deemed as being adequate to support the recovery.

- **Monetary policy decision making will be outcome based:** An important take-away was that the Fed will make its decision based on 'actual data' not 'forecasted data'. The statements made in this regard does suggest that the central bank will be reactive in taking policy decisions not pro-active as has been the case in past episodes.

Some clues about the Fed's reaction function provided: Although the Fed Chair was quick to state that the economic projections/dot plot provided does not reflect the Fed's reaction function, we think that it provides important messages. **Our key take-away was that even with inflation expected to average ~2.1% over 2021-23, the median of members in the committee is not prepared to hike policy rates.** Hence, the Fed is sticking to its framework that it wants to see an overshoot in inflation before rate hikes will be triggered. The Fed Chair spent a considerable period of time during the press conference emphasizing that the relationship between employment and inflation has become flatter and that will play a role in monetary policy decision making.

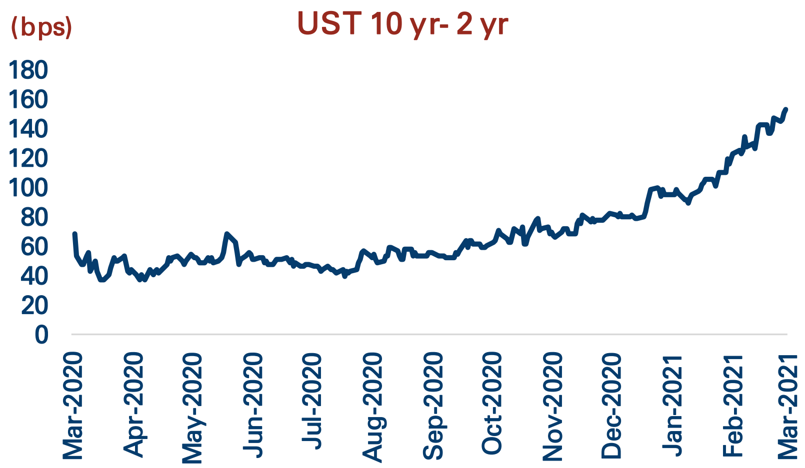
Our assessment: The policy statement, economic projections provided, dot plot and tone in the post policy press conference were largely in line with our expectations. The Fed had to downplay tightening or market expectations of rate hikes in order to ensure that monetary policy remains accommodative as the recovery is still at a fairly nascent stage. We maintain that the Fed will start to talk about tapering of purchases in Q42021 once it has had enough time to assess the pace of the recovery. An initial taper could start from Q12022 onwards. Until then, US monetary policy will be in auto-pilot mode.

Impact on markets: We did expect that markets would in the near-term view the policy outcome as being dovish given that the central bank has pushed back plans of rate hikes. However, with the FOMC meeting out of the way focus has now shifted to the outcome of the BoJ policy meeting that is due to conclude tomorrow morning (IST). Media reports indicate that the BoJ could consider widening its band for the 10-year sovereign target that it sets. Such a move in theory could imply that central bank is implicitly indicating that it will reduce the pace of its tapering of purchases. However, we wait for official clarification on this from the central bank.

The US yield curve has undergone a steepening bias that we think could persist over the course of 2021. The spread between the UST 10-year yield and UST 2-year yield has widened by 6 bps post the FOMC meeting. Short-end rates have softened reflecting guidance from the dot plot that policy rates will remain at current levels until end-2023. Longer-end yields have drifted marginally higher. We do not see the FOMC policy as working as a trend reversal and maintain that the UST 10 year will trade in the 1.4%-1.7% range in H12021 after which it is poised to head higher to the 1.7%-1.9% range. A decision on the SLR will also be due on a few days time that will work as an important driver of price action.

In the FX markets, we see some consolidation setting in the near-term. The USD could lose ground against high yielding FX—both DM and EM—in the near-term. However, we maintain our call for upside in the USD on a trade weighted basis in the medium-term as investors position for a US-led global recovery.

Chart 2: US yield curve has steepened considerably in 2021



Source: Bloomberg & ICICI Bank

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