FOMC review: Transitions to an average inflation targeting regime

- The FOMC maintained status quo on expected lines and made the changes in the policy statement as it transitioned to an average inflation targeting regime. However, the new regime was never expected to bring about any changes on the policy front. The main message was that the bias remains towards accommodation.
- While GDP projections were revised higher for 2020, several areas of risk were identified with the economic outlook described as still being ‘uncertain’.
- Unemployment rate projections were revised lower but inflation was only expected to touch the 2% mark by 2023. Hence, as the dot plot clarified policy rates were expected to remain at the zero-lower bound until end-2023.
- Given that risks to the outlook remain in place, we expect the FOMC to maintain its current framework for a considerable period of time. Possible step-up in QE if downside risks to growth materialize cannot be ruled out either.
- Even as the FOMC reassured that rates will remain low, risk aversion intensified as investors responded to the concerns on growth specifically related to US fiscal policy. Hence, the USD has re-bounded on a trade-weighted basis. We see some consolidation up ahead in the near-term in FX markets.
- This round of the FOMC policy did not provide anything new for the global rates market. Hence, the muted response. We see range trading persisting in DM yields.

Adjusting the statement: While the FOMC maintained status quo on policy rates and its QE purchases program, it made the necessary and important alterations to its policy statement to take in to account that it has moved in to an average inflation targeting regime. The specific changes made state that ‘the Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With inflation running persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved.’

In other words, the Federal Reserve has resorted to a new policy framework and by tying the economic outcome to the policy rate, it has moved towards a tentative data based forward guidance. The move to targeting ‘maximum employment’ implies that the FOMC will take in to consideration a variety of indicators on the labour market rather than just focusing solely on the unemployment rate that it has done on past occasions. Besides, we reiterate that inflation overshoots in the medium-term will be tolerated. However, the quantum of overshoot that will be tolerated will be ‘fairly subjective’.

Dissent within the FOMC on the policy statement: While the FOMC voted 8-0 for the policy actions and current pace of balance sheet expansion. There was a split in vote of 6-2 on the language in the policy statement. FOMC member Kaplan preferred that the committee retain greater flexibility beyond achieving maximum employment and prices stability while FOMC member Kashkari indicated that the ‘current target range be maintained until core inflation has reached 2% on a sustained basis. In other words, both members wanted to re-emphasize a more accommodative framework than was described in the policy statement.

On QE guidance: The FOMC also made a small change to its QE guidance that it will increase securities holdings to ‘smooth market functioning and help foster accommodative financial conditions’ from the previous policy statement that had only emphasized ‘smooth market functioning’. This was a small subtle change but so far the FOMC has refrained from linking its policy objectives to the QE program and instead kept it exclusively on policy rates. However, that could be revisited at a later date.

Projections: Policy rate at the zero lower until 2023: The FOMC raised its GDP projections for 2020 by anticipating only -3.7% YoY contraction as compared to previous forecasts of -6.5%. The sharp downward revision has come on the back of a rebound seen since the lock-down and was on expected lines. Adjustments to GDP projections were also made for 2021-2023 period during which a sharp expansion in economic activity is assumed but the pace of growth was lowered at the margin. Unemployment rates were also revised lower across the period. An important take-away was that even with projections of a sharp rise in GDP growth, inflation was not expected to overshoot the 2% mark over the period. In fact, inflation was expected to just touch 2% by 2023 implying that the overall accommodative monetary easing environment will remain intact. The net result was as the ‘dot plot’ indicated that the policy rate was expected to remain at current levels until end-2023 given that the FOMC is now explicitly targeting an inflation overshoot. Only 4 of the 17 members saw the prospect of a rate hike in 2023.

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**Economy has improved but risks remain to the outlook:** In the policy statement, economic projections and in the press conference; the message was that the rebound had been better and more robust than anticipated since the easing of the lockdowns in April. Even with a pick-up in second wave of infections, the rebound appears to have sustained. However, several areas of concern were expressed: (a) risks of second-wave of infection restraining activity via continued social distancing remains in place, (b) a vaccine will remain critical for a full-recovery to take place, (c) even with the sharp rebound witnessed, considerable economic slack remains in place and (d) areas of economic activity specifically services that entail greater human contact such as recreation and travel have remained more depressed than other sectors that require less human contact. **In short, the risks to the outlook remains ‘extraordinarily uncertain’. The pace of growth was also expected to slow from Q32020 onwards.**

**More fiscal policy is required:** The FOMC Chair continued to emphasize the important role that fiscal policy has played in reviving growth and combating the downturn during the pandemic. However, as the Fed Chair reiterated that the Fed has ‘lending powers not spending powers’ and that more fiscal support will be required. In its projections, the FOMC has assumed that further fiscal support will be provided.

**To sum-up: On auto-pilot:** The FOMC is expected to maintain its accommodative framework with policy rates remaining at the zero-lower bound for a considerable period of time, especially considering the economic projections provided. While the US economy is on the mend, several risks still remain in place until a vaccine comes in to effect. Retail sales softened on a sequential level in August highlighting that a full-scale recovery is still some distance away. The next step will be to move towards a more explicit data dependent forward guidance than the current guidance. We think that will come at a later date when the FOMC is more confident about the pace of recovery. We see that happening by end-2020 or in H12021. A further increase in the size of QE purchases cannot be ruled out either.

**Implications for the markets:** Markets’ initial response was fairly modest. However, risk aversion has intensified as investors responded primarily to the concerns about the growth outlook that were expressed by the Fed Chair. Hence, the USD has rallied at the margin with the DXY moving towards the higher end of the 92.00-94.00 range. We expect the focus to shift to the pace of recovery and specifically the developments with regard to the vaccine. We see some consolidation persisting in the near-term.

US yields had already priced in a fairly dovish outcome and low policy rates for a considerable period of time. Hence, the response has remained fairly modest. We maintain our near-term trading range for the US 10-year treasury yield at 0.55%-0.75% in the near-term.
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