A dovish Fed to keep USD weak and global yields ranged

- The outcome of the FOMC policy meeting was in line with expectations.
- The main message was that considerable uncertainty remains about the future outlook that is likely to remain contingent on the manner in which the COVID-19 infection curve pans out. Concerns about an intensification of second wave of infections were expressed.
- The improvement in economic indicators witnessed over May-June was somewhat downplayed.
- Hence, monetary policy will remain accommodative for a considerable period of time.
- The FOMC is also close to finishing its review of the monetary policy framework that should in turn result in the central bank resorting to a data-dependent forward guidance.
- The FOMC also indicated that both fiscal and monetary policy need to operate in sync to support the recovery. Focus will remain on the US Congress to pass the next fiscal stimulus bill.
- A dovish guidance along with ongoing uncertainty about the US macroeconomic landscape could mean that the USD trades weaker. This could be more concentrated against the DM block than the EM block.
- We have raised our projections on the EUR, GBP and JPY but kept our CNY and INR projections unchanged.
- RBI intervention is continuing to persist that is stopping any sharp downward move in the USD/INR pair from developing.
- Global bond yields, particularly DM yields, are likely to remain flat at record low-levels.

Outcome: on expected lines: The FOMC maintained status quo on policy rates and its monetary policy framework on expected lines. The only minor change was an extension provided to the USD FX swap facility with global central banks that was extended up to 31-March-2021. The extension does not reflect any emerging distortions in the USD funding market but has been kept in place as a backstop facility to support global financial conditions. The underlying tone was dovish with the concerns expressed about the future state of the economy that will remain contingent on the manner in which the COVID-19 virus pans out.

Policy statement: A dovish underpinning: The policy statement was unchanged. Similar to the last policy meeting, the statement assured that ‘the FOMC is committed to using its full range of tools to support the economy’. There was a mild modification made to acknowledge the recent improvement in economic indicators but that was also qualified by ‘economic activity and employment remain well below their levels at the beginning of the year’. The forward guidance was kept unchanged with the FOMC committing ‘to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.’ An important addition to the statement was that ‘the path of the economy will depend significantly on the virus’. In other words, considerable uncertainty still remains firmly in place even as there has been a tentative rebound post the re-opening of the economy.

Press conference: Uncertainty prevails: In the press conference, the Fed Chair stated that although consumption is back at about 50% of its decline seen since April, the rise in second wave of infections has started to weigh on activity since mid-June-2020. This was visible in high frequency data such as credit card spends as well as consumer confidence. He also emphasized that the pandemic is being viewed as a substantial ‘disinflationary shock’. On several occasions, he reiterated that the outlook will remain contingent on the manner in which the virus evolves. Further that it is still too early to determine the pace and duration of the recovery. He further asserted that rate hikes were not discussed and that policy will remain accommodative for a sustained period of time. His main message was that it is important to ‘hope for the best but plan for the worst’. The FOMC already has the ‘upside covered’ but needs to remain vigilant on downside risks.

Importance of fiscal policy cannot be understated: The Fed Chair was quick to acknowledge the role that fiscal policy has played in supporting growth along with monetary accommodation. However, he re-emphasized the need for more fiscal support and was encouraged by the steps taken to move towards another fiscal stimulus package.

The review of the monetary policy framework is coming shortly: On the monetary policy framework, the Fed Chair stated that it is still being discussed within the committee. Another rounds of deliberations are likely with the minutes of this policy meeting expected to reveal the progress and scope of discussions. At the conclusion of the framework, we see the FOMC moving towards an ‘average inflation targeting regime’ that will pave the way for resorting to a data-dependent forward guidance.

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US Monetary policy: The road ahead: In short, the underlying messaging provided by the FOMC was dovish with focus on the risks to growth and the need to provide as much support to the economy as is required. We maintain that the FOMC will stick to its current accommodative framework. A sharp slowdown in growth if the second-wave of infections intensifies could result in further aggressive balance sheet expansion at a later date. The next step will be to move towards a data-dependent forward guidance to provide adequate assurances that the policy rate will remain low for a considerable period of time that could come as early as in the September-2020 policy meeting.

Markets: A review of our expectations: With the FOMC providing the dual message of an accommodative framework and a dovish message, we maintain our outlook across currencies and the rates market respectively.

- **USD: Weakness to persist:** The sharp fall in the USD on a trade-weighted basis witnessed over the last fortnight had priced in a dovish FOMC as US real rates moved sharply lower. Hence, market response to the outcome was modest. However, the DXY continues to trade with a downside bias indicating the bearish sentiment that exists as concerns about the US macroeconomic landscape remain firmly in place along with an extremely accommodative local monetary environment. We maintain that the DXY will likely trade in the 93-95 range with risks of a possible downside break. The main near-term trigger will be the negotiations in the House of Congress with regards to the US fiscal stimulus bill of USD 1 tn that is due to pass.

- **EUR: In a new trading range:** The passage of the EU recovery fund along with ample USD liquidity has meant that we have raised our near-term and medium-term EUR/USD projections. We would not rule out a near-term upside of 1.18-1.19 given the momentum and if the US Congress is unable to pass a new fiscal stimulus bill. Downside is limited given the re-rating that has taken place of the Euro-zone growth profile for 2021. We assign low odds of the pair breaking sharply below the 1.14-1.15 level in the near-term.

- **INR: Held by the RBI:** Even as the anti-USD trade has intensified in the global markets, the USD/INR pair remains stuck in a very tight range. Fund flows in the form of FDI inflows and FPI equity flows have remained robust in July. The current account balance has improved as well reflecting a sharp fall in imports. However, the USD/INR pair is not being able to break sharply lower as RBI intervention is persisting that is countering the improvement in the fund flows outlook. We expect a similar dynamic to remain in place that will likely keep the USD/INR pair trapped in the 74.50-76.00 range in the near-term.

- **GBP: supported by the anti-USD trade:** The GBP/USD pair has trended higher reflecting the anti-USD trade in the global markets and risk-on sentiment that has prevailed. There has also been favourable commentary on ‘Brexit’ coming from EU policymakers who have indicated that a possible deal can be worked out. We have subsequently raised our GBP/USD projections as well and see it trading in the 1.28-1.31 range in the near-term. Renewed ‘Brexit’ uncertainty could work to restrict sharp upside in the pair.

- **CNY: Marginally stronger like most EM FX:** The USD/CNY pair has been trading with a slight downside bias reflecting the anti-USD trade but not sharply below our base-case projections. Chinese growth prospects have also shown a marked improvement in Q2 2020 relative to the rest of the world as the spread of COVID-19 appears to have been contained by a greater degree that is in turn getting reflected in fund flows in to the Chinese markets. We see the USD/CNY pair trading in the 6.95-7.05 range in the near-term. The main risk is if there is an intensification of US-China tensions that could lend more upside than we currently forecast.

- **JPY: Rallying as part of the anti-USD trade:** The USD/JPY pair has moved sharply lower than our forecasts primarily reflecting the anti-USD trade. We lower our forecasts for the pair to the 104-106 range in the near-term. The surprising element has been the break-down in relation between the USD/JPY pair and risk sentiment. Given that the JPY is a major funding currency, we do not expect these trends to sustain going forward.

- **Global yields: Stuck in a range:** We see the range trading bias to persist in DM yields with central bank accommodation working as the primary driving force. Fiscal funding concerns are not influencing price action as yet at least as far as DM yields are concerned. We maintain that the US 10-year sovereign yield is likely to remain in the 0.5%-0.8% range going forward.
Chart 1: USD has weakened across the board concentrated against DM block than the EM block

Source: Reuters & ICICI Bank Research
Treasury Research Group

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