# FOMC preview: Not ready to signal tapering as yet!

- **After the hawkish pivot in June, we expect the Federal Reserve Open Market Committee (FOMC) to provide a neutral message to the market, at the conclusion of its meeting later today**
- **We think that FOMC will want to see further progress and indications of a durable recovery taking hold, before it moves towards tapering. Some uncertainties about the outlook still remain in place**
- **We see no changes in the post policy statement, from the previous one that was provided in June**
- **From Powell's press conference, we expect: (a) confirmation that the outlook is improving, (b) FOMC wants to see more progress before it considers normalising the policy, (c) inflationary pressures could moderate in the medium-term and (d) indicate that tapering was discussed but remains non-committal on the timing of the action**
- **We maintain our constructive outlook on the US economy. We think that by September, the FOMC should get more clarity on the durability of the recovery and strength in consumption. Hence, we think that tapering could commence from November, onwards**
- **For the market, a neutral message will mean that focus will remain on the global growth momentum. As concerns about the outlook, particularly on Emerging Markets (EMs) remain in place, we expect the bullish environment for the US fixed income and USD to remain in place**
- **Concerns about Chinese growth prospects and measures being taken by the Chinese policymakers, such as on the technology sector and housing market could continue to weigh on the market**
- **If Powell's message is slightly more dovish than expected, there could be a minor short-lived retracement in the USD. In the medium-term, our bullish USD call remains intact.**

**US economy strong despite the rise in infections:** After the decisive hawkish pivot made by the FOMC in its policy meeting in June, focus will be on whether the Central Bank is ready to move forward and announce its plans to taper its asset purchases programme. Since the last FOMC meeting in June, there has been more clarity that the US economy is recovering from the pandemic.

The labour market has shown an improvement, consumer spending appears to be robust and ISM/PMI surveys continue to hover around fairly high levels, from a historical perspective. Price pressures also appear to be firming up and becoming more broad-based, than expected. **Although the US economic data surprise index has turned negative for the first time since June-2020, it reflects the unwinding of the higher investor expectations that have been built-up over the last few months. We do not think that the US economy is entering a soft patch.**

The US economy has already gone back to its pre-pandemic levels, as of end of Q22021. **We remain fairly constructive on the outlook driven by: (a) a robust income growth driven by direct fiscal transfers to households, (b) improving labour market conditions and (c) expansionary policy environment.** We think that both consumption and investments are likely to show continued strength, over the remainder of 2021. We see the Q22021 GDP growth of 9% QoQsaar that is due to be released tomorrow.

**But several uncertainties still linger:** For the FOMC to pull the trigger and move forward to commence tapering, it needs to be convinced that the economy has made 'sufficient progress' towards meeting its economic objectives of 'maximum employment' and 'a temporary overshoot of 2%'. In this regard, we think that the FOMC will want a few of the lingering uncertainties to resolve before it takes a definitive step towards normalising the policy. Some of these uncertainties include:

- Is the pandemic truly out of the way, given the recent rise in infections? Is the delta variant of the virus a new source of concern?
- Has the labour market really turned a corner? What effect will the expiry of the increased supplementary unemployment benefits in September have on the labour market?
- Is the current pick-up in private consumption a reflection of pent-up demand or will it sustain over the medium-term?
- Are inflation pressures more persistent?

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**We expect status quo:** We think that the FOMC will still want to give itself some more time before it moves decisively to taper. **We think that the FOMC should get an adequate assurance by the September meeting than at the current juncture, if as we expect the US economic indicators continue to show traction and payrolls remain fairly strong, over July-August.** Hence, we expect the current round of the policy meeting to provide an update of the FOMC's assessment on the economy but do not see any decisive action or commitment to taper the purchases. **In short, the lingering uncertainties about the durability of the recovery have still not totally faded in to the background, as yet.**

**Based on statements made post the June policy meeting, by the members of the committee, we take note of the fact that there is still considerable divergence of views among members of the FOMC.** Hence, it might be difficult to arrive at a consensus within the committee to begin unwinding the monetary stimulus, at this stage. Hence, from the conclusion of the policy meeting, we expect the following:

- **Policy statement:** After the upgrades that were made in the last policy meeting, we do not expect any changes in the policy statement. The rise in infections is unlikely to force a change in either the assessment or the outlook. Besides, the rise in infections appears to be more concentrated in under-vaccinated segments of the population than vaccinated segments that the FOMC will probably play close attention to
- **Press conference:** We expect the FOMC Chair to continue to maintain a relatively neutral tone by providing the following guidance:
  1. We expect him to continue to provide a constructive outlook on the economy
  2. However, he will clarify that the Central Bank wants to see more progress in meeting its objectives
  3. Price pressures are likely to continue to get described as being temporary in nature
  4. On tapering, we expect him to indicate that there was a substantial discussion. However, we expect him to remain non-committal on the timing of such a move.

  Overall, we expect him to provide a relatively neutral message to the market.

- In this round of the FOMC, no fresh economic projections or 'dot plot' will be provided.

**Going forward, we maintain our call of the FOMC commencing tapering of its purchases in November, with definitive indications likely in the September policy meeting.** We think that there will be sufficient evidence on the more durable nature of the recovery by that time for the Central Bank to move forward. We think that the FOMC will start by a tapering of USD 15 billion to USD 20 billion, per month, from November. It will likely end QE by Q32022. We also believe that the inflationary impulses could be more structural in nature. Although we see core PCE moving lower as supply-side bottlenecks and base-effects fade, we still expect the index to move to the 2% to 2.3% YoY range, over 2022. Hence, we think that the FOMC will start hiking policy rates either in late 2022 or early 2023.

**Market impact: Risk aversion could drive price action:** Given our expectations of a relatively unchanged commentary and guidance from the FOMC, we do not expect this round of the policy meeting to have a substantial effect on the markets. Instead, risk aversion could prevail going forward, driven by an ongoing concern about the global growth momentum and the delta variant of the virus. Economic indicators have also started to come in below expectations, led by the US surprise index adding to investor caution. Steps taken by the Chinese policymakers to clamp down on the technology sector and the property sector have worked as another important dampener. **We think that this bout of risk aversion might persist in the near-term that should continue to work as supports for the US fixed income markets and the USD.**

**US rates: Supported by softer growth outside the US:** Over the last month, the US 10-year treasury yield has fallen sharply, driven by a correction in the real yields (TIPS), not the implied breakeven inflation rate that has remained flat. The US 10-year real yield has corrected lower by ~25 bps, over the last month, reflecting a downward reassessment of growth prospects outside the US, particularly for EM economies. The US 10-year real yield has touched a record low of -1.13%. In the near-term, we see a range of 1.15%-1.40% for the 10-year sovereign yield, primarily reflecting risk aversion, as investors turn to the safety of the US fixed income market and as the Fed's purchases also works to asymmetrically skew demand. We maintain our call of 10 year real yields rising in the medium-term, as the FOMC moves towards normalising policy. We see the UST 10 year moving to the 1.6%-1.8% range by end of 2021. Given the softer than expected growth trajectory in EM economies, we have lowered our end of 2021 UST 10 year forecasts that were previously at 1.8%-2.1%.

The US yield has flattened sharply. Longer-end yields might have drifted lower but shorter-end yields have remained flat. The UST 2-year yield has hovered around the 0.16%-0.20% range over the last month. We think that the shorter-end of the curve could remain flat and rise gradually towards the end of 2021. We see the UST 2-year yield moving to the 0.25%-0.30% range by the end of 2021. The flattening bias in the yield curve could continue in Q32021 but it might steepen in Q42021.

**FX markets: We maintain our bullish USD call:** Similar to US fixed income markets, the USD is benefiting from the global growth concerns and as investors price in a US-led global recovery in 2021, we maintain our bullish call on the USD. We see a range of 91.00-93.00 in Q32021 and a range of 93.00-95.00 in Q42021. **If Powell provides a more dovish than expected message, some near-term short-lived downside in the DXY cannot be ruled out.** We also see USD/EM moving with a gradual upside bias, with momentum expected to pick-up once the FOMC moves towards normalising policy.

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