FOMC review: A hawkish pivot, much earlier than our expectations

- The Federal Reserve Open Market Committee (FOMC) maintained its status quo on expected lines but made a fairly important hawkish pivot, in terms of the guidance provided for the medium-term
- The FOMC appears to be a lot more confident about the pace of recovery, given that the infection rates have fallen sharply, on the back of the vaccination campaign. Hence, the growth projections were revised higher for 2021 on expected lines and the economy is expected to grow above its potential rate, over 2022-23
- The guidance provided on the labour market was also fairly constructive
- Inflation projections were revised higher for 2021, in line with expectations but were kept relatively unchanged over 2022-23. The Fed Chair also expressed concerns about inflation becoming more 'permanent' than 'transitory' over the medium-term, reflecting a substantial change in the guidance on 'inflation'
- The most notable change was on the guidance provided through the 'dot-plot', in which the median of the members of the committee expect 50 basis point rate hikes in 2023, from the previous guidance of no rate hikes
- On tapering, the message was that it could come in subsequent meetings, if the economy makes further progress to the Fed's 'economic objectives'
- We maintain that the FOMC could signal that it is ready to taper around Aug-Sep and that the actual commencement could take place in Nov-2021
- We maintain that the rate hikes will only commence from 2023 onwards but we see a risk of it coming earlier than we expect, which will remain contingent on the medium-term 'inflation trend'
- For the markets, a hawkish outcome could push the US yields, global yields and the USD higher.

A more hawkish message than we assumed: Our sense was that the FOMC would use this policy meeting to prepare markets for an eventual taper and need for normalisation in the monetary policy, towards the end of 2021. Status quo on policy rates and the monthly Quantative Easing (QE) programme was on expected lines but the tone was much more hawkish than we would have expected, at the current juncture. **Hence, there appears to be subtle indications of a pivot in the direction of the US monetary policy going forward.** Perhaps the most notable change was the guidance that was provided in the 'dot plot' that indicated that the median members of committee now expect a 50 bps rate hike in 2023, as compared to the previous guidance of no rate hikes.

More comfortable about the recovery: **A key take-away was the upgrades that were made on the assessment of the economy.** In the policy statement, the FOMC dropped the line of the pandemic adversely affecting the economy, although risks to the outlook continue to remain in place. Nevertheless, the Fed expressed optimism about the effect of vaccines in resulting in a continued opening-up of the economy and driving growth higher in the process. GDP growth projections for 2021 were revised higher, in line with expectations. While the GDP growth projections for 2022-23 were kept unchanged, it is still forecasted to be above the trend level, over the period.

The message on the labour market was also not as dovish, as we would have expected. The unemployment rate projections were kept unchanged and the FOMC Chair Mr. Powell emphasised that the outlook remains fairly favourable. Supply-side constraints appear to be holding back job increases temporarily but the sense within the committee was that the labour market strength could continue over 2021-22. In short, the FOMC is seeing through the disappointing payroll readings over April-May. Given that the current unemployment rate is at 5.8% and the end-2021 FOMC forecast is for it to reach 4.5%, does suggest that the Central Bank expects a spectacular bout of job additions later in the year.

Inflation projections were revised higher: On inflation, while the FOMC maintained that the recent rise can be attributed to 'transitory factors', guidance provided was 'subtly' more hawkish than expected. Inflation projections were raised for 2021, in line with the expectations taking into account the current uptrend in the momentum that was seen over March-May period. Most importantly, **the Fed Chair emphasised that there were broad indications that the inflation pressures might be more permanent in nature, implying a substantial hawkish pivot in terms of communication provided and the Central Bank's assessment on inflation.** However, forecasts for 2022-23 were kept unchanged, implying that the officials still do not see a persistent overshoot in the medium to long-term, relative to its previous forecasts provided in March.

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Chart 1: FOMC has raised its inflation and policy rate projections

Median Fed macro-economic projections				
	2021	2022	2023	Long term
GDP (%YoY)				
Jun 2021	7	3.3	2.4	1.8
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 (%)				
Jun 2021	4.5	3.8	3.5	4
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)				
Jun 2021	3.4	2.1	2.2	2
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)				
Jun 2021	3.0	2.1	2.1	
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 (%)				
Jun 2021	0.1	0.1	0.6	2.5
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 Board of Governors & ICICI Bank

'Dot plot' reveals a change in guidance: **The most notable change was in the 'dot plot' that showed that the median of the committee expecting a 50 bps rate hike by end-2023, with some members of the committee forecasting a much tighter policy rate regime.** We had projected that the shift in the median expectations would show that the 'dot plot' could imply that at least one rate hike could be in the offing in 2023. Another big change came from the fact that 7 of the 18 members are forecasting at least one policy rate increase, as early as 2022. Although the Fed Chair tried to downplay the changes made in the 'dot plot', it does signal that the FOMC policymakers are much more comfortable about reaching its economic objectives a lot earlier, than in the previous policy meetings.

Another intriguing question at this stage is what could have constituted the change in the 'dot plot' forecasts given that the Federal Reserve has moved in to an average inflation targeting regime. In the recent past, several officials have emphasised that the FOMC wants to see an inflation overshoot before it moves decisively to hike rates. However, the longer-term inflation projections have not been revised substantially higher over 2022-23. The ranges for the forecasts for the period have also been kept unchanged. Our best guess is that the FOMC officials are responding more to the 'upside potential', to inflation in the medium-term. Hence, the changes in the policy rate projections have been made. Inflation projections for 2022-23 could get revised higher in subsequent policy meetings.

Technical adjustments were made: In line with expectations, the FOMC made technical adjustments to its liquidity operations to counter the sharp downtrend that has been seen in the short-term money market rates, as USD liquidity conditions have improved considerably. The interest on the reserve balances and overnight reverse repo facility were raised by 5 bps each to 0.15% and 0.05% respectively. As the Fed Chair explained, this was done to keep the money market conditions from functioning in an orderly manner. Besides, if the FOMC wants to move towards normalising the policy gradually over the medium-term, it will want the money market conditions to function appropriately.

The outlook: **On tapering of purchases, the message from the Fed Chair was that it was discussed in the meeting but that the Central Bank will want to see further progress, before pulling the trigger.** We think that the FOMC will want to see further progress in terms of labour market conditions improving before signaling that it is ready to taper. This could come sometime in August, during the Jackson Hole meeting or in the September meeting. The actual taper could start a bit earlier than we initially expected around Nov-2021, instead of our previous expectations of Dec-Jan. We still think that the first rate hike could come in 2023 but acknowledge that it could take place earlier, if the economy performs better than expectations or if the inflation pressures prove more durable than currently assumed in the medium-term.

We also pay close to attention to the FOMC Chair's response to the question on why the committee had not revised its long-term neutral rate lower. His response was that there is a need to normalise and tighten the policy, if required, to create space to fight-off the next recession. He also provided an example of the limited room that the ECB had in terms of policy rates to fight-off the pandemic and that would be something that the US Central Bank will want to avoid in the future. His statements make us believe that if the Fed is convinced about a recovery taking hold, it could move towards normalising the policy back to the pre-pandemic levels.

Market impact: **For markets, this will work as a hawkish surprise pulling the US bond yields, global bond yields and the USD higher.** US sovereign yields have risen across the curve but the most notable increase has been seen in the belly of the curve, such as in the 5 year and 7 year segments, respectively.

We maintain our call of the UST 10 year moving from 1.45%-1.7% range in the near-term to the 1.8%-2.1% range by end-2021. The 10 year US real yield has hardened by ~10 bps in the overnight session. Over the remainder of the year, we expect a further 30-40 bps rise in US real yields, as the Fed moves towards normalising the policy.

The USD has also rallied across the board, reflecting the hawkish pivot in communication from the FOMC. Low-yielding funding currencies, such as the EUR and JPY have come under pressure, while the GBP is getting weighed down by concerns about a delay in the reopening plans of the UK Government. For the DXY, we retain our range of 89.50-92.00 in the near-term followed by a move to the 92.00-94.00 range by the end of 2021.

Emerging Market (EM) Forex (FX), such as the INR and CNY are also coming under pressure, in response to the change in guidance on the US monetary policy. The pricing in of a reduction in the USD liquidity conditions, as well as an eventual tightening in the monetary policy will likely work as a negative for the EM FX. The USD/INR pair is expected to trade in the 72.50-74.50 range in the near-term, while USD/CNY could trade in the 6.38-6.45 range.

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