# FOMC preview: Laying the groundwork for tapering very gently

- **At the conclusion of its two-day policy meeting (Jun 15 - Jun 16, 2021), the Federal Reserve Open Market Committee (FOMC) is expected to maintain its status quo on policy rates and its monthly Quantitative Easing (QE) programme. The forward guidance is expected to be kept unchanged, as well**
- **In the latest round of economic projections, we expect the FOMC to: (a) marginally raise Gross Domestic Product (GDP) projections for 2021, but keep the profile unchanged over 2022-23, (b) revise its inflation projections substantially higher, over 2021-22 and (c) increase its unemployment rate projections for 2021**
- **We expect the 'dot plot' to show that the median of FOMC members are expecting atleast one rate hike by 2023, from showing no rate hikes the last time it was released in Mar 2021**
- **We expect the FOMC to continue to sound constructive on the outlook. It will acknowledge that inflation has been higher than expectations, but reiterate that inflation pressures could remain transitory and correct lower in the medium-term. However, our sense is that the risks of inflation pressures becoming more 'permanent in nature' than 'transitory' have increased by a degree, since the last policy meeting**
- **We expect the Federal Reserve (Fed) Chair to inform the market that 'tapering was discussed' during the meeting. However, he is again likely to emphasise that any move to tapering will remain contingent on 'achieving the Fed's objectives' and realised outcomes**
- **We maintain our call of the FOMC formally announcing plans to taper over the August-October period. The actual taper could commence from December-January**
- **For the markets, we think that the outcome could be less dovish, than is currently priced in. Hence, minor upside in the DXY and US yields post the outcome of the FOMC meeting is likely**
- **However, we do not see a trend reversal in the DXY setting in place, at the current juncture.**

**The economy is growing in line with its expectations…: The recovery underway is unfolding according to plan, so far. The rapid deployment of vaccines has ensured that the infection rates have fallen dramatically thus, subsequently resulting in improved mobility.** The net result has been a revival in the service sector activity, with service sector Private Mortgage Insurance (PMIs) moving to a record high level, over May-June. The manufacturing sector is showing continued strength. US retail sales might have moderated on a sequential basis in May but that is taking place after a very sharp surge seen over March-April and reflects some substitution that is taking place from goods consumption into services consumption, as the economy continues to re-open. Overall, economic indicators have shown an improving trend.

**Going in to the policy meeting, the only concern might be that the monthly payroll figures were not as robust as expected, over April-May. However, as we have emphasised in our previous notes that monthly job hiring is being affected by 'supply-side' disruptions.** We take note of the fact that job openings have moved to a record high level and that other surveys on the labour market seem to show that demand for labour remains fairly robust. We would expect a sharp surge in payroll figures from Aug-Sep 2021 onwards, once the supply-side disruptions fade. The higher supplementary unemployment benefits that is being provided, as a part of the Biden stimulus bill that was passed in March, is due to expire in September. We reiterate that once these increased pay-outs expire, the supply of labour could pick up fairly sharply, resulting in strong monthly job growth figures. **Hence, we do not expect any concerns about the outlook to emerge at the current juncture.**

**…but inflation has been much higher than forecasted…:While the growth momentum is moving in sync with expectations, inflation pressures have been more robust and sizeable than previously assumed.** Both the US Consumer Price Index (CPI) and Personal Consumption Expenditure (PCE) based inflation have moved to levels not seen since 2008 that was prior to the financial crisis, when global crude oil prices touched a record high level. However, the FOMC has in its previous policy meetings emphasised the 'temporary nature' of the inflation run-up, over 2021.

**Looking at the internals of the drivers of US inflation over March-May, an argument could be made that there is a demand-supply mismatch that is driving inflation higher.** The rise is being driven by an asymmetric increase in categories, such as autos, used car sales and transportation services, such as airline fares and hotel tariffs that reflect the re-opening of the economy and increased mobility taking place. We would to a substantial degree agree that the current overshoot reflects the low base of last year and as supply in the near-term could take time to adjust to the rampant increase in demand, as the economy re-opens.

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**However, we think that there are growing indications that inflation pressures could be more 'permanent' than 'transitory'.** We also think that in preparing for its medium-term outlook on inflation, the Fed cannot ignore the underlying inflationary pressures from: (a) sharp surge in consumption, as the economy re-opens, (b) surplus liquidity and an accommodative monetary environment and (c) expansionary fiscal policy. While the Federal reserve is targeting an overshoot in inflation to make up for the undershoot in 2020 as a part of its 'average inflation targeting regime', an argument can be made that risks of a more persistent inflation overshoot from the 2% mark in the medium-term has increased by a degree, since the last policy meeting.

**...commentary from the FOMC officials cannot be ignored either...:Another important development has been a subtle shift in tone from the FOMC policymakers in a run-up to this policy meeting.** The hawkish members, such as Kaplan continue to make a strong case for tapering purchases, while dovish members, such as Mr Bullard and Ms Clarida have started to talk about the need to start discussing 'tapering of purchases' within the committee. At the same time, Vice Chairman Mr Lael Brainard, who is considered a dove, also in a recent speech indicated that the risks to inflation in the medium-term remain on 'both sides' that was more of a neutral message, than she has been providing in recent months. Most importantly, the minutes of the last policy meeting in April showed that ''a number of participants suggested that if the economy continued to make rapid progress towards the Committee's goals, it might be appropriate at some point in the upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases."

**...hence, we expect the following from this round of the FOMC meeting:**Our base-case is that the FOMC maintains its status quo, by keeping the policy rates unchanged and making no alterations to the QE programme of USD 120 billion, per month. **For investors, the bigger focus will be on the message and specifically on whether the FOMC believes that the recent developments warrant a change in communication about the future.** The Fed will also be providing its updated economic projections and 'dot plot'. We expect the following:

- **Policy statement: Unchanged:** We do not anticipate any substantial changes to be made. There could be a mild upgrade in terms of the assessment on the economy and acknowledgement of the recent increase in inflation. The forward guidance is likely to remain unchanged, with the Central Bank indicating that it will continue to maintain 'an accommodative stance of the monetary policy, until its economic objectives are achieved'.

- **Press-conference: Introducing QE tapering very gently:** The press conference will be critical, as investors will want an update on when the Central Bank plans to consider tapering the policy. We think that Fed Chair Mr Powell could mention that the tapering of purchases was discussed in the policy meeting but the time to move in that direction has not yet been achieved. The Fed Chair will continue to emphasise that the Central Bank needs to see more progress towards achieving its objectives, before decisively moving towards tapering of its purchases. **In short, emphasis will be placed on the fact that the move to tapering the purchases and eventually interest rate hikes will remain contingent on the realisation of actual outcomes.**

  We think that the slower than expected progress being made in the labour market could be cited as an important reason for the Fed resorting to a cautious approach and emphasising that the recovery has still not reached a level for the Central Bank to trigger tapering of purchases, as yet.

- **Economic projections: No substantial changes:** The last time the FOMC updated its projections in March, it had to take into account the USD 1.9 trillion fiscal stimulus programme that was passed by the House of Congress. This time around, it needs to take into account the recent inflation prints.

  - **On GDP growth, we do not expect any substantial changes.** A mild upgrade for 2021 is possible, reflecting the robust service sector activity but growth projections for 2022-23 are likely to be kept unchanged.

  - **On PCE forecasts, we think that upward revisions are likely to be made for both 2021 and 2022, followed by an unchanged forecast for 2023.** We expect core PCE projections to get revised higher to 3% from 2.2% end-2021 and to 2.2% from 2% for 2022. In short, core PCE projections could reflect a more persistent inflation overshoot.

  - **On unemployment, we actually think that there could be upward revisions** that might be made from a terminal rate of 4.5% for the end of 2021, given that the rate as of End-May-2021 is at 5.8%. There could also be an inflow of people re-entering the labour market, as the recovery gathers steam that might restrict a sharp fall in the unemployment rate in 2021. Small upgrades could also be made to the unemployment projections over 2022-23.

- **Dot plot to show rate hikes could commence in 2023:** The dot plot is often used as an important signalling device, as it provides a median estimate of the members of the FOMC's policy rate projections. In the March policy meeting, 7 of the 18 members voted for at least one rate hike in 2023. **Given that the inflation projections could be revised higher, over 2021-22 and subtle changes in the commentary coming from dovish members, we think that there could be 2 to 3 additional members that might vote for a rate hike in 2023. The net result will be the 'dot plot' signalling that the rate hiking cycle could commence from 2023 onwards.**

- **Technical adjustments are also possible:** Overall the liquidity conditions in the US market remains fairly sizeable that has pushed the effective fed funds lower to 0.06%. In response, the Central Bank could consider raising the interest rate on reserve balances that is currently at 0.1% and overnight reverse repo facility that is currently at 0% higher, so as to counter the surplus liquidity effect on the short-term money market rates. The liquidity take-up under the overnight reverse repo facility has been fairly sizeable, reaching record highs in the recent weeks. At some point, the FOMC will have to address the liquidity overhang that are keeping short-term money market rates and treasury bills low. We think that such a response could come either in this policy meeting or in subsequent meetings. The 'technical adjustment' should not be confused for any changes in the monetary stance or a rate hike.

**In short, we expect a status quo with the Fed emphasising that the economy has still not reached the threshold that would warrant a tapering of purchases, as yet. However, we maintain our call that QE tapering will commence around Dec 2020 to Jan 2021, with more definitive signals on this front expected to be provided around August-October period. The rate hiking cycle will likely commence from 2023 onwards.**

**Market impact: Not changing the game as yet: Judging by the price action over the last month, we think that markets have been slowly positioning for a dovish FOMC outcome. However, the underlying message could be less dovish, than is reflected in either the bond or currency market, respectively.**

In the fixed income markets, the sovereign yield curve has flattened, as longer-end yields have moderated. The spread between the UST 10 year and UST 2 year has fallen from 147 basis points (bps) from the last policy meeting in April to 133 bps. The breakeven inflation rates have dropped off, as investors have positioned for the Fed's guidance on inflation that it could be 'transitory'. At the same time, real yields have remained unchanged. We think that the bond yields could drift higher, across the curve, in response to the 'dot plot' but do not see a sharp rise in the yields as yet, given the massive amount of USD liquidity in the financial system. Hence, we see a near-term range for the UST 10 year of 1.45%-1.60%, with a move to the 1.8% to 2% range by end-2021.

In the FX markets, consolidation has been the name of the game. Both the Dollar Index (DXY) and the US Dollar (USD)/Emerging Markets (EM) have traded in tight ranges, as the investors wait for more clarity from the Federal Reserve. A less dovish message could result in a mild support for the USD on a trade-weighted basis. However, we see the consolidation phase in the Forex (FX) market remaining in place for a few more months followed by an uptrend in the USD, once the Fed actually signals that it is ready to taper. We see a range of 89.50-92.00 for the DXY to remain in place in the near-term, followed by a move higher of 92.00-94.00 by end-2021.

**In short, the FOMC emphasising that it could consider tapering and raising its policy rate projections over the forecast horizon is expected to provide a moderate support to the USD and push yields marginally higher. However, only when the actual move towards tapering is signalled will there be a more pronounced move in the market, with the USD expected to rise and the US yields expected to harden in Q42021.**

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