FOMC preview: An unchanged dovish guidance

- **Even as there has been a visible improvement in the US macroeconomic landscape, we do not expect any change in the guidance or the tone from the latest round of the Federal Reserve Open Market Committee meeting (Apr 27 - Apr 28, 2021)**
- **Some acknowledgement of an improvement in the outlook of the economy is likely in the post policy statement**
- **However, the Fed Chair is likely to continue to provide an unchanged dovish guidance by playing down either the possibility of tapering of purchases or the prospect of rate hikes, anytime soon**
- **We would not rule out some technical adjustments in response to the substantial improvement that has taken place in Q12021 in the 'core liquidity conditions' in the US markets. However, any measure undertaken is unlikely to have a significant impact**
- **From a market's perspective, a dovish guidance could ensure that US yields trade flat and will subsequently restrain a sharp upside emerging in the US Dollar Index (DXY) in the near-term. However, the USD could continue to gain against EM FX such as the INR and BRL that are witnessing a rise in infection rates**
- **Our medium-term expectations of: (a) the FOMC tapering purchases in Q1 2022, (b) a rise in US longer-end yields and the DXY over H2 2021 remain intact.**

US economy: more indications that it is on the mend: Since the last Federal Reserve Open Market Committee (FOMC) policy meeting in March, there has been an increased confirmation of the fact that the US economy is on the mend. A more pronounced recovery appears to be taking hold, as was visible in the strong labour market report and retail sales figures for Mar 2021. The ISM surveys have reached a record high. At the same time, inflation pressures are accelerating, partly driven by base-effects and by supply-side bottlenecks that are driving service inflation higher in the process. In short, the upward revisions to the economic outlook that were made in the previous policy meeting are unfolding in line with expectations. We see US Q12021 GDP printing at 6.5% QoQsaar with upside risks. We expect a further acceleration going in to Q2 2021 and Q3 2021 driven by fiscal stimulus measures, strong pace of vaccinations and pent-up demand.

US core liquidity conditions have also improved: Against the background of an improving macroeconomic landscape have been visible signs of an improvement in the US core liquidity conditions. We take note of the fact that the US core liquidity conditions, as measured by the total reserves that are held by the US banking sector have increased at a fairly sharp pace over 2021. The pace of increase of reserves has exceeded the quantum that is being infused by the Quantitative Easing (QE) programme alone. To explain how this has happened, an understanding of the Treasury General Account (TGA) that the US Treasury holds with the Federal Reserve (Fed) is required.

The TGA Account is used by the US Treasury to maintain a buffer, in order to meet emergency payments. From 2015 onwards, the US Treasury has been maintaining an average minimum balance of USD 150 billion with the Fed in the TGA. However, the size of the TGA increased sharply particularly over 2020, as the Treasury sought to increase the funding/cash balances available to meet demands from the pandemic. The amount of balance in the TGA went up to as much as USD 1.7 trillion during Jul 2020. It has been trending lower ever since that period. However, the Treasury has indicated that it plans to normalise the TGA to USD 500 billion by the end of Q2 2021 that will in turn have a fairly important implication on the underlying US liquidity conditions in the banking sector.

In its balance sheet, the Fed holds three major items as a part of its liabilities: (a) currency in circulation, (b) TGA and (c) total reserves that the US banks hold with the Federal Reserve, including both required reserves and excess reserves. If the TGA balances goes down as the Treasury plans, it either implies that there needs to be a rebalancing in the asset side of the Federal Reserve's balance sheet or a re-adjustment within the liabilities component that needs to take place.

Within the liabilities component, the currency in circulation is determined by the cash demand in the economy. Instead, it is the total reserves component that the banks park with the Fed that fluctuates on a regular basis. As the Fed buys assets as a part of the QE programme, the quantum of bank reserves go up and if the Fed allows assets to mature, the quantum of bank reserves go down. In short, the quantum of bank reserves is a measure of the underlying liquidity conditions in the US economy.

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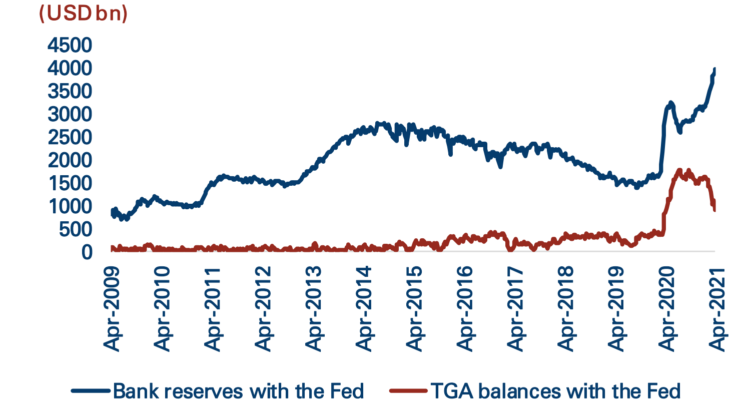
With the Fed's QE programme in operation and its commitment to reinvest in maturing securities, any adjustment from lowering in TGA balance cannot be matched by a subsequent reduction in the asset side of the Fed's balance sheet. Instead, it has to take place through an adjustment within the liabilities sub-components.

When the Treasury makes a payment to a household, as a part of the Fiscal Stimulus programme, the Fed will debit the TGA and credit the reserve account of the recipient's bank. Hence, as the treasury makes a payment that is not offset by a debt sale or tax receipt, that in turn works to drive the quantum of bank reserves higher. Hence, as the TGA balances are reduced, it will add to the overall quantum of bank reserves in the system. In short, the US liquidity conditions that are already being buffeted by QE purchases of the Fed are getting another leg-up from the reduction in TGA balances.

Chart 1: US bank reserves have been increasing at a fairly rapid pace in 2021



Source: Fed & ICICI Bank Research

Chart 2: TGA balances have been on the decline

Federal Reserve liabilities: Main components

(USD bn)	30-Dec-20	21-Apr-21
Currency in circulation	2087	2158
Foreign repos	209	226
Overnight repos	1	50
Bank reserves	3143	3836
TGA	1613	1016
Other liabilities	359	564
Total liabilities	7411	7850

Source: Fed & ICICI Bank Research

FOMC: Unlikely to make any changes in this policy meeting: While economic indicators have been surprising to the upside, we think it is too soon for the FOMC to signal that a shift in the policy is in the offing. There will also not be an update on the economic projections or dot plot in this policy meeting. We expect the following:

- Policy statement: We expect the post policy statement to make an upgrade on the FOMC's assessment on the economy. However, forward guidance is unlikely to change, with a commitment to keep the policy rates at the zero lower bound and maintain the size of the monthly purchases of USD 120 billion unchanged, until 'considerable progress is made with regards to meeting the FOMC's objectives'.

- Press conference: Markets will be more interested in understanding the assessment of the economy from the Fed Chair. We expect the following:
    1. An acknowledgement that the recovery is gathering pace, but that it would be premature to remove monetary stimulus at the current juncture
    2. He is expected to reiterate that inflation is expected to overshoot in the near-term but that is unlikely to invoke a response from the Central Bank. The Fed will remain focused on engineering a possible inflation overshoot of above 2% for a period of time
    3. We expect him to play down the possibility of tapering in QE purchases at the current juncture
    4. Overall we expect him to provide a dovish message, as he is likely to play down the prospect of tightening anytime soon. The guidance on the policy rates are unlikely to be changed either.

- Technical adjustments: We do not rule out some possible technical adjustments to overnight rates, given that the effective fed funds rate has moved to the zero lower bound and below the Interest On Excess Reserves (IOER). Typically, the IOER acts as a floor for the effective fed funds rate. With the core liquidity conditions improving further, there will be more of a downside bias on short-term money market rates that the Fed might want to correct.

In the medium-term, we maintain that the FOMC is expected to taper QE starting from Q1 2022. It will start preparing the market for such a move around Aug-Sep 2021.

Market impact: Over the last fortnight, the DXY has shown signs of stabilising and has traded with a downside bias, reflecting some visible stability in the US yield movements and a faster increase in the supply of USD liquidity in the financial system. We expect the dovish message from the FOMC to reinforce this trend.

The Biden Fiscal Stimulus programme resulted in an upward reassessment of the US growth prospects and policy rate trajectory that pushed the US sovereign yields at the longer-end, sharply higher in Q1 2021. The market is already pricing in two to three rate hikes by end-2023, as against the guidance from the FOMC of no rate hikes. With FOMC members continuing to reinforce the need for a sustained accommodation, we think that there is a limited scope for an upside potential in yields in the near-term. Besides, improving liquidity conditions are also expected to limit a sharp upside potential. We see a range of 1.45%-1.65% in Q2 2021 followed by a move higher to the 2% mark by end-2021.

In the near-term, we see a flat trajectory in the DXY of 90.00-92.00, with minor downside bias reflecting a flat US yield profile and ample USD liquidity. However, the USD could continue to gain against EM FX, such as the BRL and INR that are battling with a rise in the infection rates, respectively. Our medium-term bullish call on the USD remains in place and could commence once the Fed signals that it is ready to taper QE purchases.

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