FOMC review: An improved outlook but an unchanged policy stance

- **The Federal Open Market Committee (FOMC) maintained its status quo on expected lines, while also making an upgrade to the outlook of the economy**
- **Despite the upgrade, the guidance provided was dovish. The FOMC Chair also downplayed the prospect of tapering of purchases at the current juncture**
- **The underlying message was that the outlook is still contingent on the manner in which the 'pandemic will pan out'. Although an improvement in the economic indicators is becoming more visible, the Central Bank will probably require more confirmation that the pandemic has receded, before it can consider taking steps to normalise the policy**
- **We maintain that the Quantitative Easing (QE) tapering will kick-in from Q1 2022 onwards, with the Fed preparing the market for such a move in Q4 2021**
- **A dovish guidance along with ample USD liquidity is expected to ensure that US yields trend with a downside bias and USD trades marginally weaker in the near-term**
- **However, our medium-term expectations of a rise in the US longer-end yields and a stronger USD remains intact, as a robust US recovery is expected to take hold over the remainder of 2021**

Policy: Status quo as expected: The outcome of the Federal Reserve Open Market Committee (FOMC) meeting was in line with our expectations. The Central Bank maintained its status quo on policy rates and kept its monthly QE Purchases programme of USD 120 billion per month, unchanged as well. No changes were made to the forward guidance either, with asset purchases expected to continue until 'substantial further progress, with regards to employment and inflation was attained. Policy rates will similarly be kept at current levels until the 'inflation' and 'maximum labour market' goals of the FOMC are achieved.

Upgrades made to the economic outlook: The post policy statement did make some upgrades in terms of the outlook on the economy, as we had anticipated. The policy statement stated that 'amid progress on vaccinations and a strong policy support, indicators of economic activity and employment have strengthened. The sectors most adversely affected by the pandemic remain weak but have shown improvement.' **However, the outlook continued to be linked to the manner in which the pandemic will pan out and that risks to the economy still remain in place. During the press conference, the Fed Chair was fairly clear in emphasising that the Central Bank needs to see clear evidence that the pandemic was receding, possibly on the back of continued pace of 'vaccinations' and lowering of 'infection rates' before risks to the outlook can be changed to becoming more balanced or to the upside.**

Tapering is not being considered right now: **In the press conference, the FOMC Chair emphasised that 'it is not yet time' to discuss tapering**, although the Central Bank needs to see progress towards meeting its economic objectives, before any discussion in tapering can be considered. However, the Fed Chair was a bit vague in specifying how much progress would be adequate for the Central Bank to consider tapering in purchases.

Message on inflation was unchanged: In the post policy statement, there was an acknowledgement that inflation has risen. However, as the Fed Chair explained that the increase in FY 2021 was being driven by temporary factors such as: (a) base-effects and (b) supply-chain/supply-side effects. Inflation was expected to moderate later in the year once these temporary factors fade. The FOMC Chair continued to downplay concerns about a persistent inflation overshoot in the medium-term.

Labour market is improving: The Fed Chair indicated that the labour market was improving but that considerable slack still remains in place. He further explained that the Central Bank will not be influenced by just one print but will need to see a sustained improvement setting in before any change in the stance can be considered. He also concluded his comments on the labour market, by stating that the structural changes that have taken place in response to the pandemic are still unknown.

Financial stability and asset bubble risks were downplayed: During the press conference, the FOMC Chair downplayed 'financial stability risks' and the prospect of asset bubbles developing. He also emphasised that the leverage was low and that credit risk profile remains low, as compared to the period just before the financial crisis of 2008-09.

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Monetary policy outlook: **The policy outcome and guidance provided does not change our expectations on the US monetary policy.** We expect the Fed to continue to wait to ensure that there is a sustained improvement in growth prospects over Q2 and Q3 and that risks of another wave of infections in the US economy remains low, before it can move towards normalising the policy. We think that once there is adequate confirmation of this, we would expect the FOMC to prepare the market for a QE taper in Q4 2021 that will commence in Q1 2022. Rate hikes are still some distance away, possibly likely from Q4 2023 onwards. **An emphasis continued to be placed by the Fed Chair that the Central Bank will respond more to realised outcomes rather than forecasted outcomes, implying that the US Central Bank will be reactive than pro-active in its decision making.**

Market impact was limited: **For the markets, the messaging was in line with expectations. However, the dovish guidance along with the continued USD liquidity infusion will likely ensure that US yields stabilise over Q2 2021.** In the press conference, the Fed Chair also reemphasised that the liquidity conditions will remain comfortable that will pull the short-term money market rates lower but no technical adjustment was required at the current juncture. We see the 10 year UST yield trading in the 1.5% to 1.7% range over Q2 2021.

We maintain that there is further upside potential in the US bond yield movements, particularly at the longer-end of the curve over the course of 2021. Further fiscal support that is being proposed by the US President, as well as a robust US recovery that is expected over the remainder of the year, will work as the primary drivers for pushing yields higher in the medium-term.

The USD could continue to trade on the back-foot in the near-term, reflecting a dovish guidance and increasing core USD liquidity in the US financial markets. We see some near-term downside potential in the DXY. However, the USD downtrend could be less pronounced against EM FX that is witnessing a rise in the infection rates. Our medium-term bullish USD call remains intact.

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