FOMC review: A very gentle hint about tapering!

- **The Federal Reserve Open Market Committee (FOMC) actions and post policy statements were in line with expectations. During the press conference, the Chairman provided a relatively neutral tone in terms of the future course of the monetary policy**
- **While tapering was discussed in the policy meeting, the FOMC Chairman indicated that such a move was not 'imminent' and that the committee needs to see 'further progress', before it can move forward on this front**
- **The FOMC Chair said that the committee wants to see more progress in meeting its labour market objectives and indications of a durable recovery taking hold**
- **Inflation pressures were described as being 'transitory', but concerns were expressed that they could become more 'persistent' in nature, in the medium to longer term**
- **We think that the timing of the taper will remain 'data-dependent'. We will continue to examine the guidance provided in the FOMC minutes, the comments made at Jackson Hole, and commentary from FOMC officials, to assess whether a formal announcement will come in September as we expect, or whether it would get delayed to later in the year**
- **For the markets, the FOMC Chair remaining non-committal in terms of the timing of tapering, has been interpreted as dovish by investors. Hence, US yields could trade lower and USD could trade softer in the near-term. However, we maintain our bullish call on the USD in the medium-term going forward.**

Status quo with a neutral tone: The outcome of the FOMC meeting was in line with expectations. The policy rate and monthly QE purchases programme of USD 120 bn per month, were both kept unchanged on expected lines. The committee provided very subtle hints about moving towards normalising policies, given the 'uncertainties' that still prevail and that we explained in detail in our FOMC preview note.

Policy statement: Mild positive upgrades: The post policy statement made small tweaks, to reflect the ongoing recovery: 'economic activity and employment', were characterised as being 'continued to strengthened'. However, the statement emphasised that sectors that were hit form the pandemic 'have still not fully recovered'. The statement also said that the 'economy has made progress' towards its goals and that the 'committee will assess the progress in coming meetings' that was a change in the guidance that was provided as compared to the previous policy statement in June. The tweak in terms of guidance, would in theory suggest that the Central Bank is moving slowly towards considering when to begin normalising policy, given the progress that has been made in the recovery so far.

But tapering is still not imminent: While the policy statement made a hawkish pivot in the press conference, the Fed Chair provided a more measured tone. He emphasised that 'further progress is still warranted' before a final decision could be taken. However, he said that the committee did discuss the 'timing, pace and guidance on tapering'. He made specific references to the labour market, stating that he would want to see more progress towards its 'maximum employment' objectives. However, he did not provide a quantitative guidance of 'maximum employment'. He also ruled out the possibility of the Central Bank resorting to rate hikes, prior to FOMC completing its tapering process, indicating a definitive sequencing pattern in the terms of the road of normalisation and tightening of the monetary policy.

Inflation rise is still not considered persistent, but risks need to be monitored: Our sense from the press conference is that FOMC will give itself a six-month window to assess whether inflation pressures are more persistent. The Central Bank is still maintaining that the current rise is being viewed as transitory in nature, being driven by supply-side and temporary factors. However, Powell did emphasise that there is a risk that inflation 'could turn out higher and more persistent than currently expected'. We maintain our call that the inflation pressure rise could be more persistent than transitory, reflecting closing of output gaps and a fairly expansionary policy environment that will be something that the FOMC will have to pay attention to in 2022.

Economic outlook remains constructive: Although no fresh economic projections were provided, the Fed Chair emphasised that the outlook remains constructive. The labour market was poised to improve considerably, although the unemployment rate was still not reflecting the degree of slack that prevails in the economy. In the policy statement, the outlook continued to be linked to the pandemic. However, the FOMC Chair emphasised that the incremental hit to growth from subsequent waves, could be much more modest as households and businesses have adapted relatively well. He cited the fact that the US economy fared better during the second wave of last year, than the first wave to make his point.

Standing facilities were introduced: After a debate for almost three to four years, the FOMC moved forward with the introduction of two standing repurchase (repo) agreement facilities: (a) a domestic standing repo facility (SRF) and the repo facility for foreign and international monetary authorities (FIMA repo facility). The SRF facility will be priced at 25 bps above the policy rate working, as a back-stop facility for the local markets, limiting sharp disorderly movements in case of a liquidity squeeze like the one that was seen in Mar 2020. The FIMA repo facility will help in easing global USD liquidity pressures, in case they arise from time to time.

Explaining recent bond yield movements: The Fed Chair provided three key reasons for the recent price action in the fixed income market: (a) concerns about growth and the delta variant, (b) expectations that inflation overshoot will remain temporary and (c) technical factors.

Outlook will remain data dependent: The tone and guidance that was provided in the press conference would suggest that the FOMC is still waiting for more confirmation on the durability of the recovery, before it moves forward towards normalising policy. There also appeared to be considerable divergence in opinion among the members of the FOMC. Hence, the timing of future outcomes will remain 'data dependent'. In theory, the guidance provided in this policy meeting would suggest that the FOMC will be as patient as possible, in moving towards tapering purchases, subsequently implying that it might want to give itself more time to assess the progress being made and whether the delta variant is working to weaken the economy. We will continue to examine the guidance provided in the FOMC minutes, the comments at Jackson Hole, and commentary from FOMC officials, to assess whether a formal announcement will come in September as we expect or whether it would get delayed to later in the year. Rate hikes were ruled out by the Fed Chair at the current juncture, as he indicated that such a move was not discussed. However, we maintain that initial rate hikes could commence either at late-2022 or early 2023, on the back of growing inflation concerns.

For the markets, the outcome was dovish: The Central Bank remaining non-committal on the timing of tapering has worked as a dovish outcome. Both US longer-end yields and the DXY have fallen in response to the tone provided. We maintain our near-term ranges for the UST 10-year yield at 1.15%-1.40% and the DXY range of 91.00-93.50 in the near-term. Our medium-term projections remain unchanged. We maintain that the FOMC will move forward with its plans to begin normalising policy, reflecting an improving US macro-economic landscape and rising inflation rates.

Chart 1: US economic indicators are showing a broad-based improvement

	ISM Manufacturing PMI	ISM Non-Manufacturing PMI	Retail Sales (% MoM)	CB Consumer confidence Index	Michigan Sentiment Index	NFP ('000)	Unemployment rate (%)	Durable goods orders (% MoM)	Building Permits (% MoM)	Industrial Production (% YoY)	NFIB Small Business Optimism Index	Capacity utilisation	S&P Case-Shiller Housing Price Index (% YoY)
Jun-21	60.6	60.1	0.6	128.9	85.5	850.0	5.9	0.8	-5.3	9.8	102.5	75.4	N.A
May-21	61.2	64.0	-1.7	120.0	82.9	583.0	5.8	3.2	-2.9	16.1	99.6	75.1	17.0
Apr-21	60.7	62.7	0.9	117.5	88.3	269.0	6.1	-0.7	-1.3	17.5	99.8	74.6	15.0
Mar-21	64.7	63.7	11.3	114.9	84.9	785.0	6.0	1.3	1.7	1.5	98.2	74.6	13.4
Feb-21	60.8	55.3	-2.9	95.2	76.8	536.0	6.2	1.3	-8.3	-4.9	95.8	72.7	12.1
Jan-21	58.7	58.7	7.6	87.1	79.0	233.0	6.3	2.4	7.1	-1.7	95.0	75.0	11.2
Dec-20	60.5	57.7	-1.2	87.1	80.7	-306.0	6.7	1.5	3.7	-3.3	95.9	74.1	10.2
Nov-20	57.7	56.8	-1.4	92.9	76.9	264.0	6.7	2.2	6.3	-4.7	101.4	73.3	9.2
Oct-20	58.8	56.2	0.1	101.4	81.8	680.0	6.9	1.0	0.4	-4.8	104.0	72.9	8.1
Sep-20	55.7	57.2	2.0	101.3	80.4	716.0	7.8	1.6	4.4	-6.6	104.0	72.1	6.7
Aug-20	55.6	57.2	0.8	86.3	74.1	1583.0	8.4	2.0	-1.3	-6.6	100.2	72.3	5.4
Jul-20	53.7	56.6	1.4	91.7	72.5	1726.0	10.2	9.8	19.0	-7.0	98.8	71.5	4.2
Jun-20	52.2	56.5	8.7	98.3	78.1	4846.0	11.1	11.3	4.0	-11.0	100.6	68.7	3.5
May-20	43.1	45.4	18.2	85.9	72.3	2833.0	13.3	10.6	13.9	-16.2	94.4	64.7	3.6
Apr-20	41.7	41.6	-14.7	85.7	71.8	-20679.0	14.8	-11.6	-20.8	-17.7	90.9	63.4	3.9
Mar-20	49.7	53.6	-8.6	118.8	89.1	-1683.0	4.4	-20.7	-6.5	-5.3	96.4	73.4	3.9
Feb-20	50.3	56.7	-0.2	132.6	101.0	289.0	3.5	0.9	-4.6	-1.4	104.5	76.3	3.5
Jan-20	51.1	55.9	0.6	130.4	99.8	315.0	3.5	-4.8	6.7	-2.1	104.3	76.1	3.1
Dec-19	47.7	55.6	0.2	128.2	99.3	161.0	3.6	2.6	-3.7	-2.2	102.7	76.5	2.8
Nov-19	48.2	53.9	0.3	126.8	96.8	234.0	3.6	-6.6	0.0	-1.9	104.7	76.8	2.5
Oct-19	48.3	54.6	0.5	126.1	95.5	195.0	3.6	2.2	4.9	-2.4	102.4	76.5	2.2
Sep-19	48.3	52.9	-0.6	126.3	93.2	221.0	3.5	-0.1	-2.7	-1.8	101.8	77.2	2.1
Aug-19	48.4	55.8	0.5	134.2	89.8	195.0	3.7	-1.7	8.0	-1.4	103.1	77.5	2.0
Jul-19	51.0	54.2	0.7	135.8	98.4	193.0	3.6	2.1	7.3	-1.4	104.7	77.1	2.0
Jun-19	51.3	55.0	0.4	124.3	98.2	175.0	3.6	2.0	-4.6	-0.9	103.3	77.4	2.1
May-19	52.2	56.2	0.3	131.3	100.0	63.0	3.7	-5.1	0.0	-0.1	105.0	77.6	2.3
Apr-19	53.6	55.6	0.4	129.2	97.2	219.0	3.7	-1.3	1.6	-1.1	103.5	77.5	2.5
Mar-19	55.3	57.0	1.5	124.2	98.4	168.0	3.8	5.2	0.9	0.6	101.8	78.1	2.5
Feb-19	54.2	58.8	0.0	131.4	93.8	-50.0	3.8	-3.6	0.7	1.1	101.7	78.1	2.8
Jan-19	55.7	56.5	1.2	121.7	91.2	237.0	4.0	4.1	-3.2	1.9	101.2	78.7	3.4

Source: Bloomberg & ICICI Bank.

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