Boring Fed 'music to the ears' of EM World

Fed policy is negligible factor for the dollar in 2018 and the FOMC minutes didn't disappoint here

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USD: Fed's pre-set course is a bore for the dollar, but good news for EM FX

We see Fed policy as a negligible factor for the USD in 2018 – and the latest set of FOMC minutes did not disappoint here. The binary nature of views within the committee on big-picture economic issues like the equilibrium unemployment rate, the factors behind currently low US inflation and the level of the neutral interest rate, suggests to us that the Fed will continue to muddle through 2018 on their planned pre-set course. With markets already pricing in 60bps (ie, more than 2 hikes) worth of Fed tightening for 2018, we think US monetary policy will provide little upside to the USD over the coming year. Indeed, FX markets thrive on unpredictability and mispricings – and therefore monetary policy as a driver for currencies packs more punch in economies where the gap between actual policy rates and neutral interest rates is the biggest.

For the US, if one were to view terminal rates to be around 2.0-2.5% – markets are pretty much pricing this in. Debating over a few hikes here or there won't set a new trend for the dollar. US monetary policy can only be a factor for the USD in 2018 if we see a major regime shift – or something that causes a split Fed moving cohesively towards either the dovish or hawkish spectrum:

- On the hawkish side, the tail risk is that we see the appointment of strong hawks to the 4 open Fed Governor positions. Even though hypothetically this may create a bit of short-term noise in markets, we think the hard economic data will ultimately prevail the economic ideologies of new policymakers.
- On the dovish side, the tail risk is if the Fed were to take its symmetric inflation mandate more strictly and embraces the idea that constant missing of its 2% target requires a more gradual policy approach than currently signalled. This was indeed flagged in the FOMC minutes – with some members stating that the Fed should consider studying alternative frameworks such as price-level targeting (we've previously noted how this would imply lower US policy rates).

Neither tail risk seems likely under a Powell-led Fed – where continuity seems to be the most likely path forward. Yet, while the predictability of Fed policy will be a bore for the USD – it will be music to the ears for risky assets. Certainly, our view of a benign global risk environment – and a conducive backdrop for EM FX – is based on the assumption of a risk-averse, pre-set Fed.

CAD: Jan BoC hike is a bit too early but solid macro data warrants hawkish tilt

The Canadian dollar has been on fine form of late – not least due to external factors such as the resilience in oil prices (including a rebound in Western Canada Select crude) and a benign global environment that has favoured high-beta currencies. Canadian macro data has also been promising over the past month – with a sharp pickup in various core CPI measures making the upcoming Bank of Canada policy meeting (17 Jan) slightly more interesting. While it may be a tad too early for the central bank to resume its hiking cycle, any hawkish signal from Governor Poloz could be seen as teeing markets up for a March rate hike (60% priced in). Industrial production data (today) and the December jobs report (tomorrow) may help fuel a small positive re-pricing at the front-end of the CAD rate curve and take $/CAD below 1.25. A hawkish BoC is also why we expect AUD/CAD to move lower (initial target 0.96).