FOMC FX and rates preview: A high bar for hawkish surprises

Markets have scaled back their dovish expectations of late, allowing some room for a dovish surprise. The balance of risks for the dollar seems slightly tilted to the downside, while we may see a flattening in the UST curve

Federal Reserve Chairman Jerome Powell

Source: Shutterstock

As highlighted in our Fed preview, we are expecting a 25 basis-point rate cut tomorrow. The move is now fully expected by the markets, so it is fair to assume that the underlying reasoning and the forward guidance will be the key factors in the assets' reaction function.

Why we're expecting a 25bp rate cut from the Fed tomorrow

The 'dot plot' as a USD driver: This time is different

The Federal Open Market Committee will also publish updated forecasts and the focus will be on the so-called “dot plot”, that collects anonymous projections about the interest rate path in the coming years for all FOMC members.

Before the latest so-called 'dot plot' was released last June, we investigated the historical correlation between a cut in the dot projections for the following year and a weaker dollar. The table below shows how in June 2019 - along with the seven previous instances - the downward revision in the following year median dots (in the latest case, end-2020) corresponded to a weakening of the dollar.

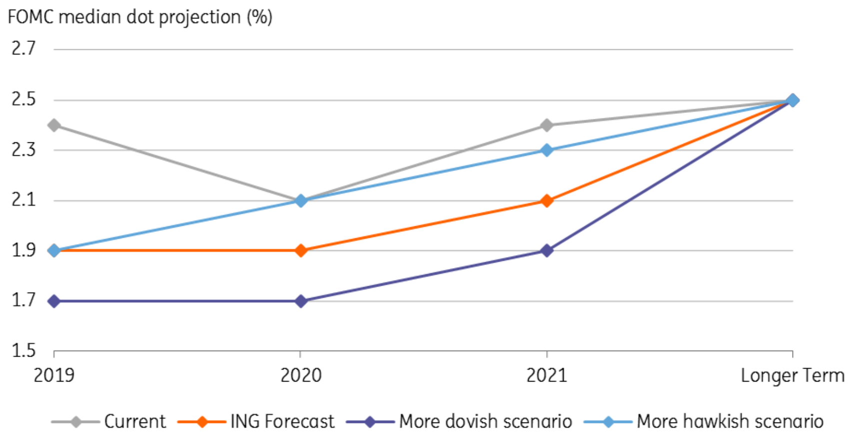
Figure 1. USD and the dot plot revisions

FOMC meeting date	Median Dot projections change (end of next year, bp)	DXY performance (24h around meeting)	Best G10 Performer VS USD
19/06/2019	-50	**-0.54%**	CAD
20/03/2019	-50	**-0.65%**	SEK
19/12/2018	-25	**-0.07%**	NOK
21/09/2016	-50	**-0.37%**	JPY
15/06/2016	-25	**-0.33%**	NOK
16/03/2016	-50	**-0.77%**	CAD
17/09/2015	-25	**-0.91%**	EUR
17/06/2015	-25	**-0.74%**	NOK
17/12/2014	-25	**1.14%**	-

Source: Bloomberg, Fed, ING

This time, however, things are different. For the first time since the introduction of the dot plots in 2012, the Fed has cut rates in July 2019. And it is almost certain, it will cut again tomorrow, as it publishes the new dot projections. The downward adjustment in the 2020 dots is therefore a natural consequence of lower fed fund rates: the end-2019 and end-2020 median dots will automatically shift to at least 1.9.

Figure 2. Where will the median dot projection fall?



Source: Fed, ING

The Fed can sound more dovish than expected: here’s how

Markets seem to be pricing what our economics team is forecasting - a 25bp cut and unchanged forward language.

A few weeks ago, this would have been read as a hawkish statement and triggered an upside correction in rates pushing the dollar higher. Now, after a steady scaling-down of dovish expectations, the bar for a hawkish surprise is higher. This means that it is far less likely to see a higher-rates/high-dollar reaction in the aftermath of the announcement.

By contrast, two sets of factors may be read as dovish and trigger some dollar weakness: the dot plot signalling another rate cut and/or a more concerned tone in the statement or the press conference.

1 The dovish dot plot

Figure 2 shows our forecast for where the median dot projection will be tomorrow, along with two alternative scenarios (one more dovish, one more hawkish). We suspect the median dot will signal no more cuts for 2019 and 2020, as robust core inflation and wage growth may hold the FOMC members from overcommitting in terms of easing.

This would keep the Fed behind the curve, which is what markets are expecting and hasn't so far been able to defy markets expectations for rate cuts. In June, the dots were adjusted by only half of what the curve was showing, and they were signalling no cuts for 2019.

At the same time, we see some non-negligible risk that the 2019 median dot will fall to 1.7, hence projecting another cut by year-end and suggesting a repetition of the three-cuts cycle that we saw in 1995/96 and 1998.

2 The details in the message

Markets may find reasons to find the announcement more dovish than expected in the details of the statement and during the press conference. First, there is some risk that James Bullard may vote for a 50bp rate cut, which may push the balance of the statement on the dovish side (although Rosenberg and George almost certainly voting against the cut could offset the impact).

Second, Powell may show a more concerned tone about the rising geopolitical tensions, especially in light of recent developments in Saudi Arabia. In these regards, any talk of rising commodity prices hurting the US consumer would also be interpreted dovish. He will also get questions about the spike in the overnight repo.

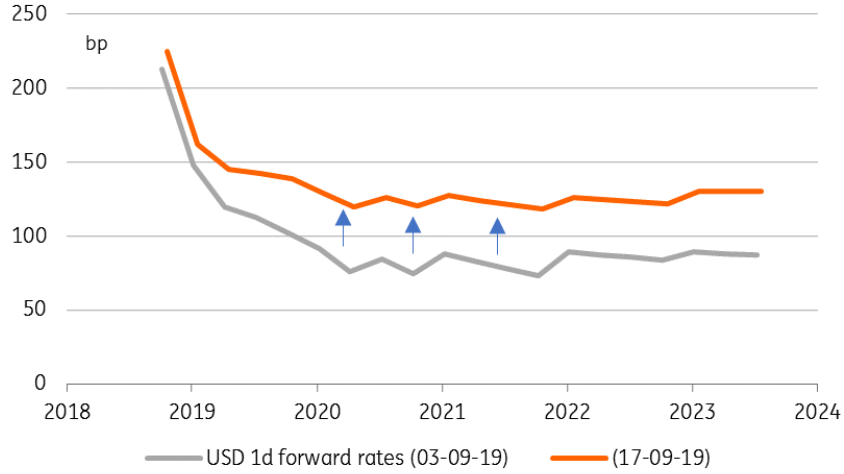
Rates: more value at the long-end

We find the outlook for the front-end of the Dollar curve relatively balanced due to a sharp hawkish re-pricing but with still more dovish expectations than our central scenario.

We see scope for longer US Treasuries to retrace their recent sell-off, flattening the curve as a result. We target 1% 10-year UST yield by the end of the year.

The hawkish re-pricing that has taken place since the start of September has erased almost two rate cuts from the OIS curve in the coming year. So now, for the near-term, we believe the market is correctly priced for our US economist's central scenario of a rate cut in September but no further dovish language. The curve is still pricing almost four cuts by September 2020 (including 25bp this week) which is more dovish than our expectation of 75bp of cuts by Q1 2020.

Figure 3. Markets have scaled down rate cut expectations



Source: Bloomberg, ING

Whilst this is an interesting development, we see more value in longer tenors. We note that after the rates sell-off this month caused by an improvement in trade tensions between the US and China, headlines seem to cause little further upward momentum in rates. In our view, this suggests investors are now fully satisfied the prices now reflect the more conciliatory tone. We are of the view that the improvement in risk sentiment rests on shaky ground and that the UST sell-off this month renders the risk-reward of being long attractive.

More relevant to tomorrow's meeting, we find the Fed's non-committal approach to easing will limit the front-end's ability to reflect any deterioration in sentiment. Any durable increase in oil price and geopolitical risks would be such an instance of the market perceiving the Fed as being constrained by above-target core inflation.

Room for a weaker dollar: NOK could be the outperformer

Ahead of tomorrow's meeting, we think that the bar for a hawkish surprise is now higher compared to only a couple of weeks ago suggesting limited scope for a USD-positive reaction and a major sell-off in UST after the announcement.

In fact, we see some scope for a dovish surprise, which can be delivered either through signalling a third rate cut in the dot projections (median dot lowered to 1.7) or by a slight change of tone in Powell's language about the negative risks stemming from the worsening geopolitical backdrop.

We see the balance of risks for the dollar slightly tilted to the downside. If our suspicions about a weaker dollar materialise, pro-cyclical currencies are likely to stand out as outperformers, with NOK and CAD likely to lead the pack, thanks to a highly supportive oil backdrop. Of the two, we see more value in NOK, for a number of reasons:

1. NOK is undervalued according to our short-term fair value model;
2. As shown in figure 1, NOK has often been the outperformer when the dollar dropped in tandem with a downward revision in the dot projections;

3. The Norges Bank meets on Thursday and may hike rates or signal an imminent hike;
4. The dovish Fed may help cement expectations that the Bank of Canada will cut rates in October (which is also our view), thereby possibly limiting the appeal of CAD.

Authors

James Knightley
Chief International Economist, US
james.knightley@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

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