How much does the dot plot matter for the USD?

Cuts in the dot projections have historically triggered USD weakness. The impact on the dollar will be determined by how closely FOMC members match the market's dovish pricing

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Dot projections in the spotlight

As the FOMC meets later today, investors are bracing for a dovish shift in the monetary stance, as highlighted by our economists in "Fed to signal cuts are coming".

The policy rate is widely expected to be kept on hold for now, so the focus will be on forward-looking indicators such as the dot projections. Every three months, FOMC members anonymously submit their forecasts about where they think the rates will be after three years. The median value of the projections is highly regarded by market participants as a tool to assess the timing and magnitude of the Fed's monetary policy changes.

Given the aggressive market pricing for rate cuts in the last few months, dot projections will likely be the key variable in the markets' reaction function.

Historical evidence hints at USD weakness

Currently, the Fed's dot plot is forecasting one rate hike by the end of 2020, far from the nearly four cuts priced in the OIS curve. Starting from 2012, we analysed all the occasions where dot projections for the following year have been cut by the FOMC. The table below shows how the members reduced their policy expectations in relation to what the market was pricing before the meeting, along with the reaction in the FX market.

FOMC meeting date	Median Dot projections change: upcoming year (bp)	Dot projections - OIS pricing before meeting (bp)	DXY daily change	Best G10 Performer VS USD (1D chg)
19/06/2019	-75 *	120	-0.5/-1.0% *	NOK *
20/03/2019	-50	99	-0.65%	SEK
19/12/2018	-25	68	-0.07%	NOK
21/09/2016	-50	92	-0.37%	JPY
15/06/2016	-25	122	-0.33%	NOK
16/03/2016	-50	138	-0.77%	CAD
17/09/2015	-25	74	-0.91%	EUR
17/06/2015	-25	71	-0.74%	NOK
17/12/2014	-25	76	1.14%	-

Source: Federal Reserve, Bloomberg, ING

* ING predictions

With the exception of the 2014 December meeting, the dollar index staged losses on the day of the meeting every time the FOMC cut the dot plot. In the G10 space, risk-sensitive currencies came up as the outperformers, with NOK leading the pack on three occasions.

Three scenarios for the dot plot and the USD

Before the most recent dot update in March 2019, the spread between the dot projections and the OIS pricing for end-2020 was almost 100 bp. The Fed covered approximately half of the gap by updating the dots and the DXY sold off (-0.65% in the day). We suspect that during the meeting, the FOMC could readjust its dot plot by 75bp to the downside, changing their expectations for one rate hike to two cuts. This would likely be accompanied by a language indicating that the Fed is “closely monitoring the risk” and would pave the way for “insurance” rate cuts in the event of a fierce economic backlash from escalating trade tensions.

This would be the strongest downward revision since 2012 and would cover most of the current 120 bp of difference with the OIS pricing. The 1 year- 2 year segment of the curve would likely stay pressured and the DXY index could drop by 0.5-1.0% on the day. We have also included two other scenarios, each of which hints at different adjustments towards the end of 2020 dots and a different outcome for the USD.

Scenario	Language	Fed rationale	End-2020 dot adjustment	DXY impact 24h
Fed resists market pricing	Labour market remains "strong" and economic activity is "solid". Fed retains "patient", but is "assessing" the risks	Too early to signal any easing. There is conviction over growth & inflation path, but they stand ready to act should the outlook deteriorate	-25bp	0.0 / + 0.5%
Fed lays the groundwork (ING base case)	Economy expanding at "moderate pace". Drops "patient" and is "closely monitoring" the risks. Fed will "act as appropriate to sustain expansion".	The economy remains in decent shape, but insurance cuts are being prepared in the event that the trade conflict is unresolved, risking a pronounced downturn	-75bp	- 0.5 / - 1.0%
Fed gets ahead of the curve	Jobs growth and activity has "slowed". Drops "patient" and is "closely monitoring" the risks, which are "skewed to the downside"	Fearful of a more pronounced downturn, the Fed wants to enjoy the benefits of early and aggressive cuts by signally 100bp easing cycle	-125bp	- 1.0 / - 2.0%

Source: ING

If we are right with our call for the Fed 2020 dots to be cut 75bp, we think USD/NOK might lead the dollar lower (at least for the short term) in what should be a pre-emptive and reflationary move from the Fed. Even though a 25bp Norges Bank hike to 1.25% is priced in for tomorrow, we think tighter Norges Bank policy can keep the NOK supported and a dovish Fed could trigger a USD/NOK reversal to the 8.65 area.

We expect the review of the dot projections to be the major market driver today. With only one exception, historical evidence shows downward revisions in the dots prompt USD weakness on the day of the meeting.

Our economists believe the adjustment in the dots may signal that FOMC members expect two of the four cuts priced by the market for end of 2020. All things considered, we expect USD to be under pressure across the board today, with NOK possibly standing out as the key outperformer.

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

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

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

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