

## US: Fed caution as momentum fades

A slightly more downbeat assessment from the Fed re-affirms the view of stable policy in coming months. However, if the vaccination program gains momentum and consumer spending rebounds sharply on re-opening, QE tapering will increasingly become a theme for markets



Federal Reserve

Source: Shutterstock

### Fed remains on hold

The Federal Reserve has left monetary policy unchanged with the Fed funds target range remaining 0-0.25%. The Fed also reiterated that they will continue with their quantitative easing program, which involves \$120bn of monthly asset purchases split \$80bn for Treasuries and \$40bn for MBS “until substantial further progress has been made toward the committee’s maximum employment and price-stability goals.”

The rest of the statement is little changed from the one released in December, although they do acknowledge that “the pace of the recovery in economic activity and employment has moderated in recent months, with weakness concentrated in the sectors most adversely affected by the pandemic”. They warn that the health crisis “continues to weigh” on activity, employment and inflation while it poses “considerable risks to the economic outlook”.

In the press conference Powell again argued that the economy is a long way from being healed and by implication that withdrawing the stimulus too early outweighs the risks from withdrawing it later.

## Guidance suggests ongoing loose policy

The forward guidance on interest rates is clear with the Fed's own projected policy path having rates on hold at the lower bound through 2023. Their dot diagram shows just 5 of 17 FOMC member believing rates will rise before 2024.

However, the guidance on QE is very vague. The Fed have not explained what "substantial further progress" constitutes, although Jerome Powell did state that they will give plenty of warning ahead of any changes and that it could be "some time" before that progress is made.

The Fed are inevitably going to get more and more questions surrounding what they have planned, especially if an accelerating Covid vaccine program allows for a re-opening of the economy from 2Q onwards.

## Federal Reserve Assets (USD tn)



Source: Macrobond, ING

## A day of reckoning is coming

If we are right and pent-up demand fueled by a massive savings glut and ongoing fiscal stimulus leads to 5%+ GDP growth this year, that questioning will get louder. Then, if inflation picks up markedly – we look for 3%+ headline CPI as price levels in a vibrant, re-opened, supply constrained economy are contrasted with those of an economy in dire-straits in 2Q/3Q 2020 – the challenge to justify the scale of QE will become even greater.

Remember that the Treasury purchases part of QE was “only” \$45bn per month in 2013 when they started tapering. Today it is \$80bn per month. At an annualised rate that is \$960bn, equivalent to 4.5% of GDP.

## Taper tantrum 2.0?

Jerome Powell was a leading proponent of slowing the pace of Federal Reserve asset purchases in 2013, but the experience from the resulting taper tantrum, where 10Y Treasury yields nearly doubled to 3% from 1.6% in four months, is making him more reticent this time.

Based on our forecasts for a reflationary environment, Treasury yields should rise, but the Fed will be wary of yields moving too far too fast. If the Fed were to reduce asset purchases it would likely add to the upward pressures and if handled badly, yields could spike violently as in 2013.

This would create significantly market volatility and lead to disruptive moves on the cost and availability of domestic credit, with implications for broader asset classes, including emerging markets. Extricating themselves from QE without some negative repercussions is going to be almost impossible, especially in an environment where more government debt issuance is on its way.

## A slow twist

We suspect that the tapering, when it comes, will be gradual and is likely to involve a twist operation to start – cutting the total purchases, but weighting more of those purchases towards the long end of the curve and away from the short end. The short end is in any case pinned down by the Fed's forward guidance that a rate hike is unlikely before 2024.

Such action may help mitigate against a sharp steepening of the yield curve, but the Fed may feel the need to announce even greater flexibility, i.e., not sticking rigidly to a monthly target for asset purchases and instead focus on a range for asset purchases by a certain date. They would be signaling they are prepared to halt the taper and actually increase purchases on a temporary basis, depending on market circumstances. This could reduce the likelihood of a major sell-off in Treasuries and help dampen volatility.

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Based on our macro view this process could start before the end of this year. Consequently, we look for more yield curve steepening with the 10Y initially targeted as heading towards 1.5% with a year-end forecast of 1.75%. We are also increasingly of the view that the first Fed rate hike will be 2023 and not 2024.

## Treasury strategy – 1% remains key

The impact effect of the FOMC outcome was for the US 10yr to edge away from a potential break below 1%. It did briefly break below 1% earlier in the morning, but that was just for a brief look. It still does not feel right for a break below to happen here, but at the same time any material sell-off in the risk asset space means that the risk for a break below 1% for the 10yr remains.

Looking forward, our central case sees the 10yr holding at above 1%, holding there for a time, and then ultimately edging back towards prior January highs. But there is also an uncomfortably high

probability attached to the risk case scenario where the 10yr breaks back below 1%. If so, an additional important test is whether it remains in the 90bp range, where we were for practically all of December. We think it would. That would be a different type of launch pad, but still one that would project an eventual reversion higher.

The ultimate risk case is where the 10yr breaks below 1%, and follows that up by breaking below the 90bp range, back into the 60-90bp range. That would really unravel all real near term reflation expectations. We feel this is a much lower probability outcome; one that would likely require some quite severe risk-off. Our base case still looks upward for yields, either from a 100bp launch pad (base case), or worst case from the 90bp area. The latter would mean going further down before heading back up again though.

## **FX outlook: Fed policy remains dollar negative, other CBs push back**

No significant changes to the FOMC statement mean that the dollar should remain pressured by deeply negative US real interest rates on the one hand and the attractiveness of overseas opportunities on the other. Yes, the dollar bear trend has found some support in January – but we do not think that is down to the Fed.

On the former, no signs from the Fed that it is ready yet to taper its US\$120bn of asset purchases, nor even think about tinkering its forward guidance on interest rates should keep US real interest rates deeply negative. If we were to see a ripple in Fed pricing, e.g., 3m USD OIS rates priced two to three years forward starting to rise significantly – then the dollar could get some support. That has certainly not been the case today.

That the dollar bear trend has stalled in January we would say is down to broadening lockdowns in Europe and some re-appearance of the virus in parts of Asia – cooling expectations of the synchronised global recovery in 2H21.

That has seen the influential declines in USD/Asia stall this year. At the same time, we are starting to see more concerted pushback from other central banks over the dollar decline. Sweden, Israel, Chile and India have all discussed increasing FX reserves for a variety of reasons – though suppressing local currency strength must also have played a role.

And over the last 48 hours, the ECB looks to be make a concerted move to weaken the EUR – threatening a rate cut in response to a stronger Euro and also launching a study as to why over recent months EUR/USD went up, when nominal rate spreads went down.

But unless the Fed is prepared to apply the monetary brakes and drive real interest rates higher (particularly at the short end of the curve) or investors really lose confidence in the 2H recovery thesis, we expect the dollar bear trend to resume later this year, probably in 2Q21.

## Authors

### James Knightley

Chief International Economist, US

[james.knightley@ing.com](mailto:james.knightley@ing.com)

### Padhraic Garvey, CFA

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

### Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

[chris.turner@ing.com](mailto:chris.turner@ing.com)

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