

US: Steady Fed - Not taper ready

The FOMC minutes did help glean a bit more on Fed thinking, but in a way these are minutes from an economy that was not running as hot as the one we see pushing through the gears now. The Fed is calm in the face of inflation upside, and no taper signals as of yet. Until there are much clearer signs that the Fed is prepared to take its foot off the accelerator, we believe the current dollar rally is a bear market correction and that it does not need to push too much further ahead



Federal Reserve

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The FOMC minutes - Leaves the back end unprotected from inflation risks ahead

The central tenet from the Fed's minutes is no material change in tone – still dovish. At the same time the Fed has nodded approval for the December stimulus, and on the likely positives coming from vaccine effects on the economy in due course. The Fed has shown no panic on inflation as of yet, acknowledging the likelihood for a “spring jump”, but also noting that the economy is far from where it needs to be. There is also no material evidence that the Fed is considering a near-term tapering, with conditions not likely to be met for some time, they suggest.

Not a whole lot for bonds to get excited about here. But at the margin there is a strong tint of a Fed that is indeed likely to take some inflation risk ahead, not seeing it as worrisome at this juncture, which reduces protection for long end rates, and should allow them to test higher. The impact effect has seen the 2yr ease lower in yield, acknowledging the ongoing dovish signal from the Fed. Longer tenor rates are showing a tendency to edge higher. Back end protection from the Federal Reserve is minimal at this juncture, even with a pop in inflation and a better economy.

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There was an interesting reference to front end liquidity conditions. The Fed noted that reserves were projected to rise rapidly through the summer reflecting the ongoing QE program, but also the Treasury choosing to spend chunks of the \$1.7bn sitting on the Fed's balance sheet. Our note is that this will add liquidity to the system, placing downward pressure on money market rates. The Fed alludes to the rate on excess reserves (IOER) and repo as a means to ensuring that the effective funds rate remains above zero.

This, in fact, is code for a potential IOER rate hike. Such a move would be purely technical, but is added evidence of the need for more work to control the excess of liquidity in the system.

FX: Minutes provide no fuel to the dollar rally

The dollar headed into the release of these January FOMC minutes on the strong side. The strong January US retail sales release earlier in the day had been the driving factor and a market running core short dollar positions was bracing for some fresh input from the Fed.

But we think dollar bulls will struggle to find much from the FOMC minutes to support their cause. True, the Fed had more confidence in the medium-term outlook based on vaccine progress. But there were no signs of the Fed, at this stage, being concerned about the economy running too hot.

And it looks like the Fed was already preparing for the communication challenge of inflation pushing above 2% in 2Q21. Here 'participants emphasized that it was important to abstract from temporary factors affecting inflation – such as low past levels of prices dropping out of measures of annual price changes or relative price increases in some sectors brought about by supply constraints or disruptions – in judging whether inflation was on track to moderately exceed 2 percent for some time.'

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believe the current dollar rally is a bear market correction and that it does not need to push too much further ahead.

Indeed, the performance of EM currencies this year – where many EM high yielders have even matched the dollar advance – is impressive. We therefore suspect that many investors will take advantage of any near term dip in cyclical currencies, including the EUR, and position for an advance against the dollar resuming in 2Q21, when further evidence of vaccine rollouts and lockdown unwinds emerge.

Although the minutes come after a run of strong data, a consistent theme in recent weeks

The FOMC minutes came against a backdrop of an exceptionally strong retail sales number – up 6% in January; that's practically an annual change in one month. A typical monthly rise would be in the region of 0.4% (includes inflation). The big driver was low income households, indicative of the real effects of the December stimulus. It shows how important such stimulus has been both to the US economy, and to the households in question that were forced to hold back in December. We also had the latest producer price inflation reading for January, which showed core producer prices at 2% above last year. Not only was this double the Street estimate, but in a flash we have a 2% pipeline inflation economy; no sign of deflation here.

The FOMC minutes did help glean a bit more on Fed thinking, but in a way these are minutes from an economy that was not running as hot as the one we see pushing through the gears now. The US 10yr could have used these data as an excuse to push on higher. But, as we have noted in the past day or so, there has been a decent enough move to the upside over the past week. Too fast too quick would be unsettling for risk assets, risking a self-correction for bonds.

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