USD: Looking for clarity from the Fed

Clarity over 2H17 policy sequencing and the Fed's reaction function to 'somewhat rich' asset prices are what we're looking for within the June FOMC minutes.

Source: iStock

Mixed messages over the Fed's 2H17 policy sequencing

The general consensus remains the Fed will hike once more and begin its balance sheet wind down towards the end 2017, though the order in which this could occur is still unclear. Some Fed members may prefer to start the balance sheet process in September as an interim rate hike solution, with a view of actually increasing the Fed funds rate in December when the US economy has fully recovered from its transitory dip. This sequencing idea is most consistent with market pricing, with odds of a September rate hike currently less than 30%, while a full rate hike is all but priced in for December.

What do 'somewhat rich' asset prices mean for Fed policy?

Fed talk last week floated the idea of a possible complacency in risk appetite. From the Fed's perspective, the significant year-to-date flattening of the US yield curve is likely to be of equal worry. While a recovery in US data should see this trend reverse – and the curve starts to steepen – some members may cite concerns over pushing too hard with policy tightening as it risks a further flattening of the US curve and potentially a nasty unwind of the risk-parity trade which explains the 2Q rising equities and falling yields environment. Today's minutes may shed some light on the Fed's reaction function to recent financial market developments.

But big picture focus remains on White House policies

While our short-term USD outlook is positive, once we've seen a potential 25bp worth of hawkish Fed re-pricing by markets or extremely bearish USD sentiment correct a bit – then from a cyclical perspective, the dollar will once again turn its attention to Washington and the White House policy agenda.