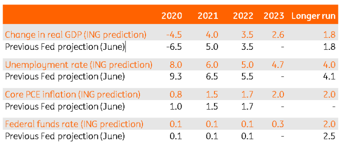
THINK economic and financial analysis

Bundle | 16 September 2020

What to expect from the Fed today?

In this bundle



	2020	2021	2022	2023	Longer run
Change in real GDP (ING prediction)	-4.5	4.0	3.5	2.6	1.8
Previous Fed projection (June)	-6.5	5.0	3.5	-	1.8
Unemployment rate (ING prediction)	8.0	6.0	5.0	4.7	4.0
Previous Fed projection (June)	9.3	6.5	5.5	-	4.1
Core PCE inflation (ING prediction)	0.8	1.5	1.7	2.0	2.0
Previous Fed projection (June)	1.0	1.5	1.7	-	-
Federal funds rate (ING prediction)	0.1	0.1	0.1	0.3	2.0
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United States

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The new normal – “averaging” 2%

Under the Federal Reserve’s old regime, the policy was to pre-emptively raise interest rates before inflation reached 2%.

This was based on the belief that the time lags between policy announcements and the impact on the real economy meant delaying action risked allowing inflation pressures to get out of hand. This could mean that either the competitiveness of the US economy would be undermined or that interest rates would need to rise sharply to control price pressures, which could threaten an economic downturn.

Numerous inflation downside misses over the years has since led to a change of thinking. The conclusions of last month’s Federal Reserve strategy review showed that under their assessment of the “new normal” for the US economy both the long-run trend rate of US economic growth and the estimates for neutral interest rates is lower than previously thought.

In consequence, the point at which declines in the unemployment rate start to generate inflation has fallen, limiting the scope for a meaningful pick-up in inflation.

This can be seen in the numbers. Since the beginning of 2010 the Fed’s favoured measure on inflation, the core personal consumer expenditure deflator, has been at or above 2% in just 13 months – so a hit rate of one in 10 – posting an average of 1.6% year on year over the past decade.

The Fed to tolerate periods of inflation modestly in excess of 2% 'for some time'

Significantly, the Fed acknowledged inflation shortfalls can be just as bad as inflation overshoots – through dragging down inflation expectations and creating “an adverse cycle of ever-lower inflation and inflation expectations” that lead to lower market interest rates, which gives the Fed “less scope to cut interest rates to boost employment” during a downturn. Therefore, to offer some compensation they will now tolerate periods of inflation modestly in excess of 2% “for some time” – hence the shift to an average inflation target of 2%.

The conclusion is that the Fed is now acknowledging they ran policy too tight in recent years.

What does it mean for Fed policy?

While there is unlikely to be any policy change at this meeting given the decent activity and employment backdrop and the recent rise in inflation, we are assuming there will be a change of language within the statement given the Fed’s shift in thinking. There will also be new updated economic and interest rate forecasts and a clear message from the press conference that interest rates will remain lower for longer than would otherwise have been the case.

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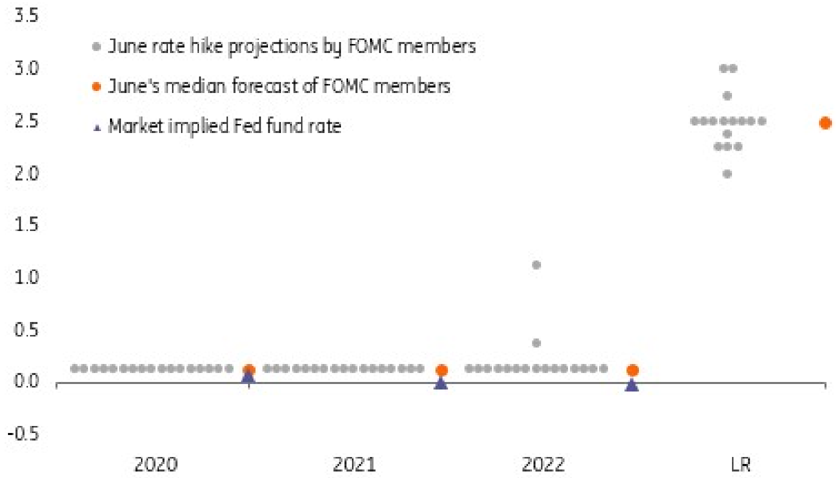
Currently, the language in the FOMC statement reads as “the Committee expects to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals”. In its new form it will take on board the emphasis on “shortfalls” from maximum employment levels and “average” for 2% inflation.

Officials have also been mulling whether to formally adopt time guidance, such as saying interest rates will not be raised for two years. Alternatively, they could use outcome-based assurances, such as saying they will not raise rates until inflation has sustainably hit 2% and perhaps adding a figure for the unemployment rate.

However, there is little real need at the current juncture given interest rate expectations are on the floor for the next few years and the Fed’s dot diagram of individual members rate hike projections is signalling nothing before the beginning of 2023. We are shifting to the view that we are quite a way off before the Fed needs to step in with more forceful language on the timing of rate hikes.

Fed "dot plot" from June



Source: Federal Reserve, ING, Bloomberg

As for the updated forecasts we are likely to see growth expectations revised higher to reflect the recent stronger data, with unemployment revised lower. However, we don't expect to see much change in the inflation projections nor to the interest rate predictions out to 2022 – the June Fed dot plot diagram only had two of sixteen members predicting a rate rise before end-2022 and we don't see anyone joining them.

The interesting thing will be what they have to say about 2023 as they extend out their forecast range by another year. We tentatively suggest there is a consensus behind one rate hike before the beginning of 2024, but this is not a strong conviction call. We also wouldn't be surprised to see the long-run expectation for the Fed funds rate revised lower given the new thinking within the Fed.

ING's expectations for Federal Reserve's new forecasts

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Change in real GDP (ING prediction)	-4.5	4.0	3.5	2.6	1.8
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Source: ING

Low for a very long time

Either way, Jerome Powell will use the press conference to reinforce the message that the Fed has no interest in raising interest rates anytime in the next couple of years, which should help to anchor the short-end of the yield curve even more.

We also see little meaningful upside pressure on the long end of the curve coming from this week's meeting. There had been some recent upward pressure on longer-dated treasuries given anxiety about the Fed's renewed focus on delivering higher inflation would mean for fixed coupon payments over many years. Nonetheless, saying they want higher inflation and delivering it are very different things.

With the US economy continuing to face numerous challenges and the slack in the labour market meaning little prospect of wage inflation, the chances of the Fed meaningfully improving on its hit rate for 2% inflation anytime soon don't look great.

> *Either way, Jerome Powell will use the press conference to reinforce the message that the Fed has no interest in raising interest rates anytime in the next couple of years*

In any case, Powell will leave the door open to further potential action, most likely involving additional QE, but will once again emphasise that the Fed can't generate demand. For that, we will need to see additional fiscal stimulus, but that is looking only a remote possibility ahead of the 3 November elections.

Author

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

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Source: Shutterstock

What to look for from the Fed today? Still a steepening bias

We'll be watching two key items from the FOMC outcome. First, the posting of an end-2023 dot is mooted. The odds heavily favor a replication of 2022, 2021 and 2020 i.e. no change from where we are today. Last time there were a couple of dots above current levels for 2022, and we'd likely see that again in 2023, perhaps joined by another one or two. That would suggest a bit of a debate on where the turning points for rates could be.

The overall impression from the dot plot outcome should be to leave the markets with the firm impression that the front end is absolutely anchored. That brings us to the other key element - will there be any uplift in the inflation forecast? As it is the Fed has long run inflation at 2%. The question is would they dare to throw in an above 2% inflation number - a nod of acknowledgement towards the average inflation target mandate that they have taken on.

Even if there is no explicit inflation forecast uplift, the fact that the Fed has moved to average inflation targetting is still a big deal.

> *"Yes, just saying it is not enough to generate inflation. But then again, saying it is still different from not saying it."*

There is much speculation on whether the Fed will be more specific on what average inflation targeting will actually entail. We are of the opinion that participants will be disappointed on that front. Ultimately the Fed does need some flexibility at turning points; suffice at this juncture to assert that if or when we get to that point where inflation is running at above 2%, the Fed will not be panicked into a pre-emptive rate hike.

So far the long end is betting that a break above 2% is unlikely. Probably right, but risk/reward also suggests that more insurance should be taken out in ultra-long exposures. That's why curves are upward sloping in the first place - we just don't know for sure out there.

We still think the curve should be steeper, not dramatically, but just a tad to acknowledge the existence of inflation average targeting.

We don't expect anything big though. It's the last FOMC before the election; not the time to be a discussion point from a political perspective.

No pre-FOMC FOMO for EUR investors

For once, EUR investors might not be affected by their FOMC-day FOMO (fear of missing out). Three ECB speakers are lining up for today's session. Two of them, Lane and Holzmann sit at opposite ends of the dove-hawk spectrum. The former, incidentally the ECB's chief economist, has been particularly vocal before and after the September meeting to highlight the downside risks a higher EUR exchange rate poses to the inflation outlook.

Hard as he has tried, Lane has failed to land a durable blow to the common currency. Since his latest outing raised the spectre of additional rate cuts, he is likely to receive increased attention from rates investors however. Truth be told, EUR money markets are already pricing a non-negligible chance of easing next year which would dampen the rate market impact of further comments raising the possibility of a cut.

We will let our FX strategy colleagues address the efficacy a 10bp cut in the deposit rate on the currency. From the point of view of rates markets, we think their ability to anticipate further cuts will be limited as central bank officials have flagged the proximity of the effective lower bound. More importantly perhaps, investors might be tempted to question the wisdom of another deposit rate cut to stem a temporary rise in the EUR when the ECB has had no opportunity to subsequently tighten policy.

Today's events: FOMC, German supply, ECB speakers

In addition to this evening's FOMC meeting (see preview above) and to the ECB's speakers (ditto, Hernandez de Cos completes the trifeca), Germany sells 30Y debt today.

Authors

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

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Fed Chairman, Jerome Powell

USD: FOMC to reiterate the lower for longer message

The FOMC meeting is the main event of the day.

With the move towards average inflation targeting being priced in (following Chair Jerome Powell's speech in Jackson Hole) the focus will be on the new updated economic forecasts. As per our FOMC preview, we may see an upward revision to the GDP outlook (reflecting the recent stronger data) but both inflation and interest rate forecasts out to 2022 are unlikely to change much.

This mix of a better growth outlook and an indication of looser policy for longer should be modestly supportive of risk assets and keep the US dollar softer today.

EUR: Getting a helping hand from the Fed

Should the Fed deliver the message of a higher GDP forecast but low rates for longer, this should be modestly positive for EUR/USD and take the cross closer to the 1.1900 level today.

In the Central and Eastern European space, the Czech koruna has recently been meaningfully underperforming its CEE peers, with EUR/CZK breaking through the 26.80 level yesterday. We see (yet again) the stretched long CZK positioning as the main factor behind the scale of the CZK fall. Long CZK has been a high conviction fundamental CEE trade since the peak of the Covid crisis.

We don't see any fundamental change to the CZK's outlook at this point and estimate that it now trades with a large risk premium vs the euro (around 2%). We expect EUR/CZK to find strong resistance in the 26.800-27.000 area.

GBP: Short-lived support from global risk sentiment

Improved risk sentiment and a softer USD helped sterling (both vs the dollar and the euro) but given the heightened Brexit risk, we expect the positive spillover from global factors into sterling to be short-lived and muted.

Both August UK headline and core CPI surprised on the upside this morning (down less than expected), but the risk to the Bank of England's stance remains heavily skewed to the dovish side due to the mix of an uncertain economic outlook and increased hard Brexit risk.

BRL: BACEN to perform delicate balancing act

Brazil's central bank meets today and is unanimously expected to keep the Selic rate unchanged at 2%.

As Gustavo Rangel discusses in his Brazilian outlook, BACEN has not ruled out further rate cuts but is wary: of (i) inflation (especially PPI) reversing higher and (ii) the fiscal risk premia emerging in the *real* and perhaps growing were BACEN to take real rates deeper into negative territory.

We think USD/BRL is finely balanced and could see a symmetrical reaction to a dovish or hawkish surprise. The benign external environment leaves us with an overall bias for 5.20/25 over coming months – as we outline in September's FX talking.

Authors

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

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

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