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Article

What to expect from this week's Fed meeting

The May jobs report and a rebound in both car sales and mortgage applications suggests the economy is experiencing a more vigorous rebound than anticipated. However, we suspect the Fed will give a more nuanced assessment, warning of many potential potholes in the road ahead. More stimulus, not less, remains our expectation for the months ahead

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The return of the V?

There has been a real disconnect between equities (and risk markets in general) relative to interest rates over the past couple of months. The former is seeing only the positives while the later was far more cautious about the prospects for recovery. Last week that changed with some good car sales numbers followed up by another remarkably strong set of mortgage approvals for home purchase, rounded out by an astonishingly strong jobs report, which has caused extreme embarrassment to anyone who calls themselves an economist (myself included).

Talk of potential negative interest rates in the US has evaporated with the potential for a vigorous V-shaped recovery pushing the S&P 500 to within touching distance of its all-time highs. Even longer-dated Treasury yields couldn't ignore the story and moved towards three-month highs. The key question now is, what does the Federal Reserve make of it all?

But there are potholes in the road ahead

Officials have in general chosen to take a very cautious tone regarding the economic outlook and we believe that will continue. They will no doubt be wary that getting too enthusiastic risks inflating asset prices even more at a time when there are still huge economic and health uncertainties.

Yes, Covid-19 cases are falling, but in states that have reopened there has been some evidence of a renewed pick-up in transmission of the virus which, if it continues, could potentially see lockdowns reinstated. Moreover, as we head towards winter there are worries about a second spike as Covid-19 has a more amenable environment in which to spread.

Then there is the economy, which is expected to contract at around a 40% annualised rate in 2Q20 and then, even after last Friday's jobs numbers, we have to remember that employment remains 19.6 million below February's level. While the US is on the reopening path there is clearly the potential that as companies bring their staff back, there isn't enough work for them to do – e.g. a restaurant limited to 30% maximum capacity or a retail outlet in a major city that has no footfall because all the offices are closed. Staff could see themselves laid off for a second time.

Moreover, given the downturn in global economic activity, many manufacturing and professional service firms may not need as many workers as they face up to the new economic environment of weaker corporate profits and higher debt levels. As such, unemployment is likely to fall slowly with an 8-10% figure for the end of this year our central forecast. This should contribute to keeping inflation pressures muted.

Fed to leave to door open for more stimulus

Given this backdrop, the Fed will leave the Fed funds target rate unchanged at 0-0.25% and we suspect they will refrain from offering much new forward guidance. Their Mainstream Lending Program is finally coming on stream and that will reinforce the view that Fed action will continue to support the economy in addition to numerous other lending facilities that are already operational.

Their quantitative easing has been tapered significantly with just $4 billion per day of Treasury purchases scheduled for the coming week versus $75bn at the peak. We suspect they will retain the language that they will continue the purchases "in the amounts needed to support smooth market functioning, thereby fostering effective transmission of monetary policy to broader financial conditions".

In terms of the outlook for policy, the new forecast summary of projections – the first published since December – will provide an insight into how the range of views within the committee is shaping up. We suspect that there is a decent chance they will pencil in one rate rise before the end of 2022, which may help to dispel some talk of the potential for negative rates. Fed officials have been dismissive of this as a tool and we do not expect it to be implemented.

One future option that is gaining traction is yield curve control – using QE to target specific yields to prevent borrowing costs rising too much too quickly. However, given the latest rise in yields is driven more by optimism in the recovery rather than excess supply related to ballooning issuance, the Fed will hold off for now. However, if the initial reopening bounce in activity wanes and the US economy hits one of the many potholes we foresee, this policy option will come up for active Fed discussion.

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