14 June 2021

Fed Research

Preview: Start talking about talking about tapering?

Key takeaways

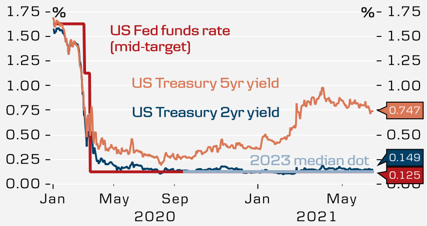
- We doubt that the upcoming Fed meeting will be a significant one.
- In particular, we are looking for changes in the communication on QE. We think the Fed will repeat that bond buying will continue at the current pace "until substantial further progress has been made" but that Fed Chair Powell will acknowledge that tapering discussions have moved closer at the press conference.
- We expect the Fed to signal one rate hike in 2023 (from zero currently).
- FX: Tighter liquidity in the US and China will strengthen USD eventually but the exact timing remains highly uncertain.
- Fixed Income: We see risk tilted to the upside for Treasury yields this week but we probably need to see the actual tapering announcement before we should expect a new significant move higher in US treasury yields. We still see 10Y US treasury yields around 2% year-end.

Watch out for Fed communication on QE

We doubt that the Fed meeting will be a very significant one. Inflation has moved higher but inflation expectations are still at acceptable levels given the Fed's new average inflation regime (for more details see *Research US: Higher inflation but not spinning out of control due to still well-behaved expectations*, 14 June), so **the Fed is likely to repeat that some of the price increases are transitory in nature (i.e. repeat that *"Inflation has risen, largely reflecting transitory factors"*)**. If anything long-term market-based inflation expectations like 10yr breakeven inflation has actually moved a bit lower recently. Clearly, the Fed is employment-focused at the moment and employment still remains significantly below the level before the pandemic. We discussed the Fed's reaction function in more detail in *Fed Monitor: "Still a long way to go" – Fed is currently employment-based*, 10 May. **On outlook risks, we expect the Fed to repeat that *"risks to the economic outlook remain"*.**

In our view, the most important thing to look out for is the Fed communication on QE. The Fed has repeated again and again that it will continue buying bonds at the current pace *"until substantial further progress has been made"*. Unfortunately, the Fed does not want to quantify what substantial further progress really means. We took notice of Fed Vice Chair Richard Clarida saying that *"It may well be that in upcoming meetings, we'll be at the point where we can begin discuss scaling back the pace of asset purchases"*. "A number of participants" said the same thing at the April meeting according to the *minutes*. **We think the Fed, for now, will stick to the current wording but that the Fed Chair Powell will recognise that tapering has moved closer during the press conference.** If not, we expect policymakers to say it in speeches after the meeting, when the blackout period expires.

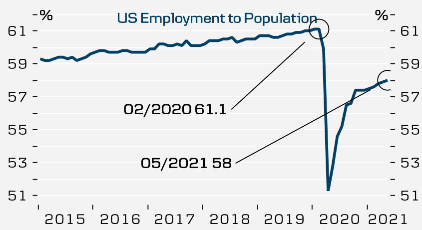
US 5yr Treasury yields have moved sideways for some time now



Note: Past performance is not a reliable indicator of current or future results.

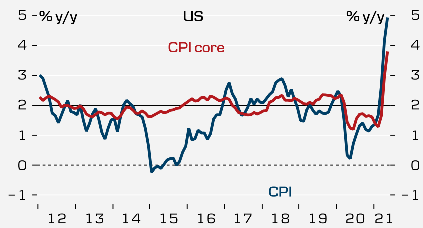
Sources: Federal Reserve, Bloomberg, Macrobond Financial

Employment-to-population remains much below the pre-pandemic level



Sources: BLS, Macrobond financial

Will the Fed ignore 5% headline inflation?



Sources: BLS, Macrobond financial

Chief Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

Chief Analyst
Arne Lohmann Rasmussen
+45 21 46 29 51
arr@danskebank.dk

Senior Analyst
Lars Sparresø Merklin
+45 45 12 85 18
lsm@danskebank.dk

The Fed publishes new projections in connection with the meeting. Normally, there is not much focus on GDP growth and inflation projections but the latter is likely revised higher. More interestingly are the so-called 'dots' showing what the policymakers think in terms of rate changes. **We expect the median policymaker to signal that Fed will hike in 2023 (from zero rate hikes through 2023 currently).** We doubt, however, the market reaction will be big given markets already think the Fed is going to tighten monetary policy earlier than what they have been signalling for a while. Markets are pricing in the first rate hike in spring 2023 and a total of two rate hikes in 2023.

Current Fed call

We expect the labour market recovery to be fairly strong this year meaning that the Fed is likely to turn more hawkish in September (the shift may come already around Jackson Hole in August ahead of the meeting), where we expect the initial real discussions on tapering to start. We expect actual tapering will start in January 2022. We expect the Fed to taper USD20bn per meeting implying that tapering will conclude in September 2022.

We expect the Federal Reserve to hike the first time in Q1 23.

FX: A more hawkish Fed may weigh on EUR/USD spot

A more hawkish Fed may weigh on EUR/USD spot. As has been the case since last year, the global easing of liquidity conditions and ensuring reflationary trends have been a tailwind for spot. However, spot seems to struggle to make new highs from current levels above 1.20, which is also in line with our valuation models suggesting that surprise potentials are low as valuations appear fair. In our view, we are in the early discussion of a liquidity tightening by US, which adds on top of the Chinese tightening since Q4 of last year. The exact timing of such tightening and the market reaction remains highly uncertain, and especially so as US jobs data has been slightly weak. But, if Fed more openly discusses tapering and rate hikes at the upcoming meeting, we would view such as an argument in favour of our 12M forecast of 1.15. In terms of timing, cross-asset momentum in inflation trades will be key to follow.

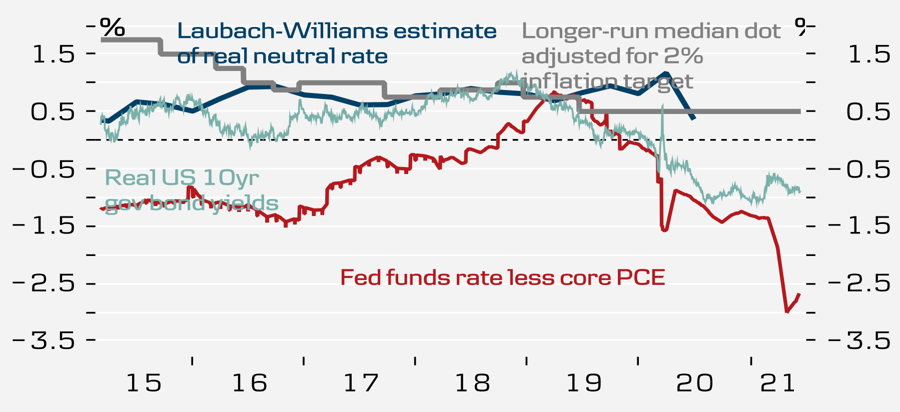
Fixed Income: Support to US treasury market to be temporary

We have seen some support to US treasuries in June despite the higher than expected CPI print for May. The drop in 10Y US treasury yields of around 15bp to 1.45% here in June reflects, in our view, that the market is increasingly buying into the Fed view that the current jump in inflation will be temporary and that tapering is not imminent. Furthermore, a significant positioning for higher yields going into June might have exaggerated the move lower in yields.

Hence, positioning in the market should be more neutral going into the FOMC. If we are correct that the dots will be revised higher and that QE has 'moved closer' we see risks tilted to the upside for treasury yields this week. However, we probably need to see the actual tapering announcement and a 'substantial further progress' in the labour market before we should expect a new significant move higher in US treasury yields. We still see 10Y US treasury yields around 2% year-end.

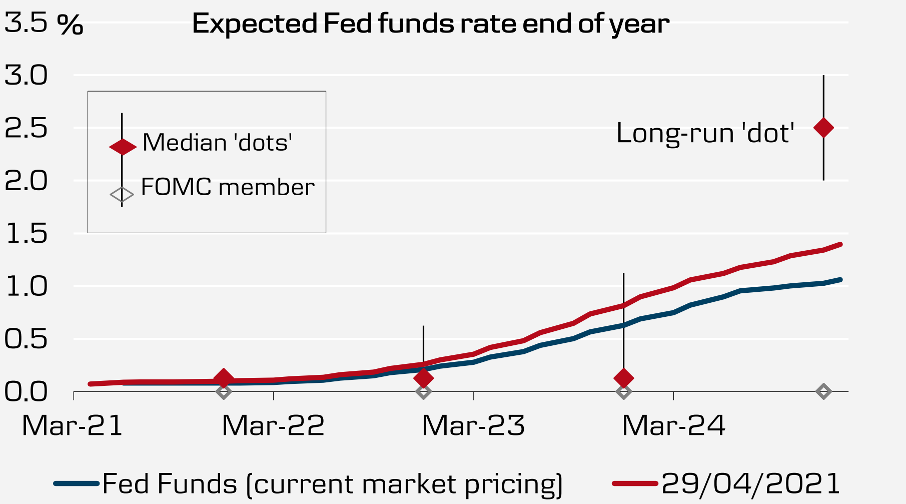
Fed charts

Monetary policy is still accommodative



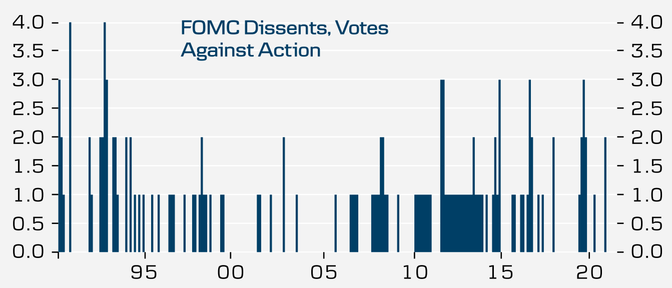
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

Investors are pricing in the first rate hike in spring 2023 (and a total of two hikes in 2023)



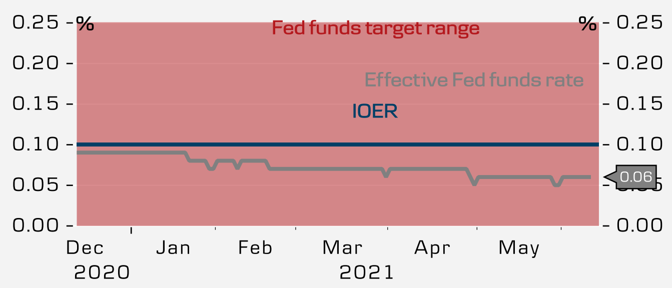
Note: Past performance is not a reliable indicator of current or future results.
Sources: Federal Reserve, Danske Bank

The FOMC members usually work by consensus



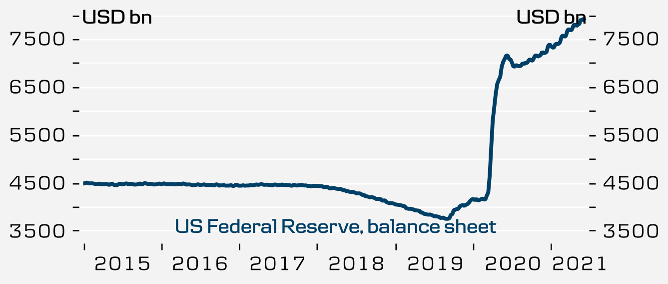
Source: St Louis Fed, Macrobond Financial, Danske Bank

The Fed may hike the IOER if effective Fed Funds rate moves further down from the current level



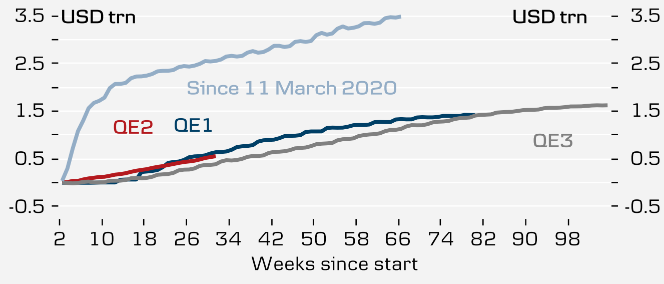
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Macrobond Financial, Danske Bank

US balance sheet has been increasing rapidly



Source: Federal Reserve, Macrobond Financial, Danske Bank

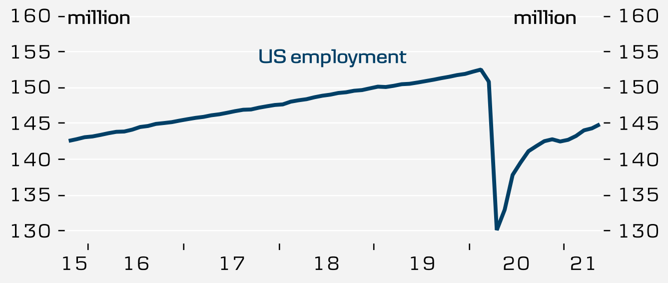
Fed still buying USD120bn worth of bonds per month



Sources: Federal Reserve, Macrobond Financial

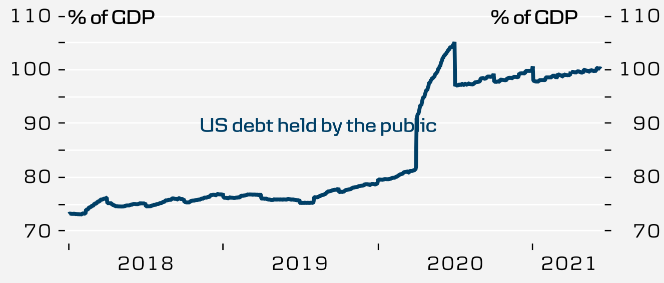
Macro charts

Employment remains significantly below pre-corona levels



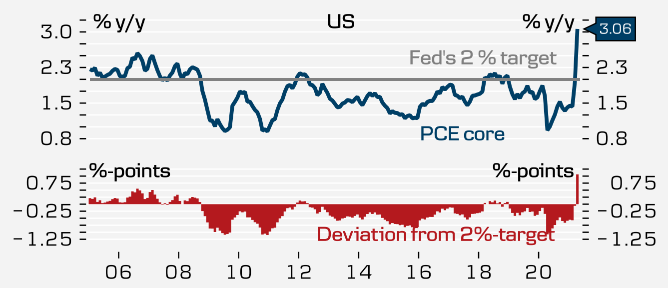
Source: BLS, Macrobond Financial, Danske Bank

US debt to increase further due to Biden's relief package



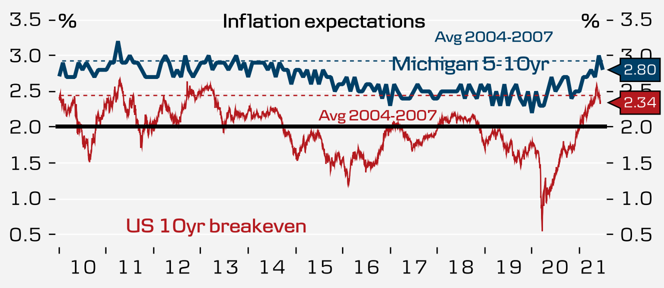
Sources: US Treasury, Federal Reserve, Macrobond Financial

PCE core inflation has moved sharply higher



Source: BEA, Macrobond Financial, Danske Bank

Inflation expectations back to where they are supposed to be



Note: Past performance is not a reliable indicator of current or future results.
Source: Michigan, Bloomberg, Macrobond Financial, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Mikael Olai Milhøj, Chief Analyst, Arne Lohmann Rasmussen, Chief Analyst and Lars Sparresø Merklin, Senior Analyst.

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