17 September 2021

Fed Research

Preview: What to do in a bad trade-off?

Key takeaways

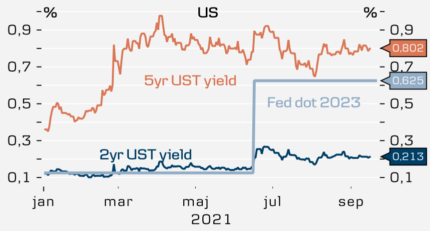
- The Fed is in a difficult position amid slower growth and still high inflation. Given the weak jobs report and lower-than-anticipated inflation in August, we expect the Fed will refrain from providing more details at this meeting, as the Fed has already made it clear that tapering is set to begin before year-end.
- We believe the tapering *pace* is more important than the timing. We continue to expect that tapering will be concluded in mid-2022.
- We expect the Fed to raise the 'dots' by signalling the first rate hike in 2022 (up from 2023 currently). We still expect the first rate hike in H2 2022 in either September or December.
- Fixed Income: We expect the imminent market reaction should be muted in the US fixed income market if we (and consensus) are right. However, we see risks tilted to the upside. We still forecast 10yr US Treasury yields in 2.0% in 12M.
- FX: The continued push towards tighter global liquidity conditions (Chinese deleveraging, ECB fading PEPP and Fed tapering) is positive for the dollar. We continue to see downside risks to EUR/USD over the coming year, targeting 1.15 in 12M (1.13 in 15M).

Fed Preview: No tapering details yet after weak jobs growth

We believe the Fed finds themselves in a very difficult situation. Normally when the economy is hit by a negative demand shock, it makes sense to ease monetary policy to support both employment and inflation. As the current situation looks a bit more like negative supply shock (although the delta variant is making the picture more blurred) with bottlenecks, lack of qualified workers, rising commodity prices, higher inflation (expectations) and so on, **the Fed has to decide whether to fight high inflation (tighten) or low employment (easing). At least, the high inflation prints and increasing inflation expectations (especially 1-5 years expectations) among households make it more difficult for the Fed to remain patient.**

There were a lot of speculations that Fed Chair Jerome Powell would announce more details about tapering in connection with his speech at Jackson Hole, which he did not. **After the weak jobs report for August, we think the Fed will refrain from giving more details at the upcoming meeting, which is in line with what investors and consensus think.** Waiting a bit longer also gives the Fed a bit more timing analysing why the jobs report was weak. Was it just noise or a signal of something else? We discussed exactly that in *US Labour Market Monitor: Weak jobs report – noise or a signal of something else?*, 13 September. The lower-than-anticipated CPI inflation print for August also supports this call.

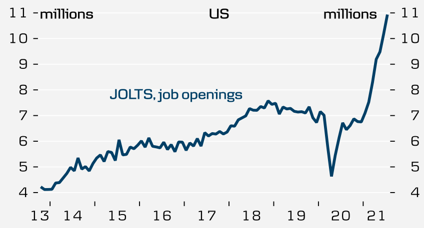
US yields versus June dots



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

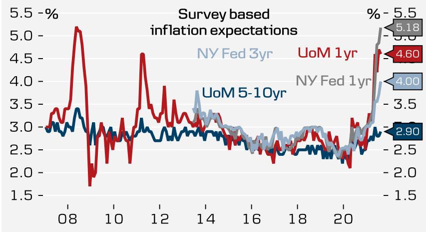
Sources: Federal Reserve, Bloomberg, Macrobond Financial

Weak jobs report but very high demand for labour



Sources: JOLTS, Macrobond financial

Higher inflation expectations, especially near-term



Sources: NY Fed, University of Michigan, 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

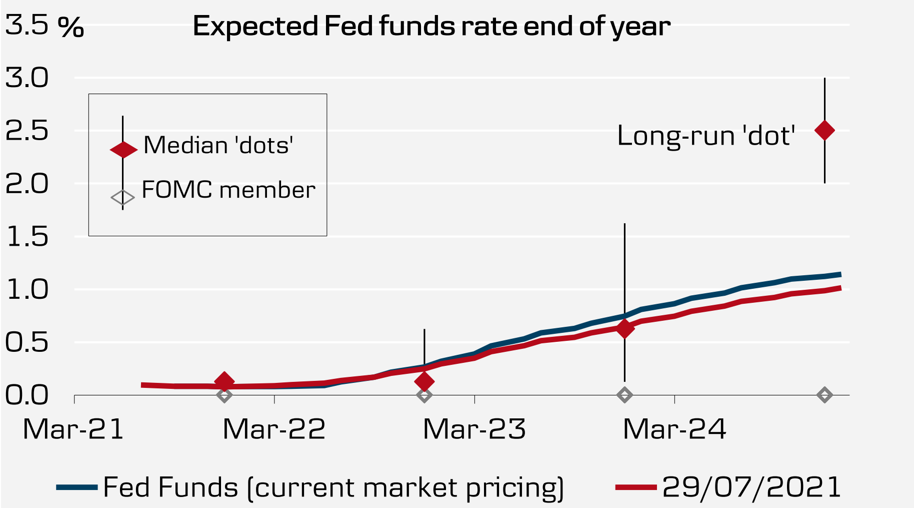
Senior Analyst
Lars Sparresø Merklin
+45 45 12 85 18
lsm@danskebank.dk

Given that most FOMC members have made it clear that it most likely would be appropriate to start tapering before the end of the year (and given that we have discussed this theme for so long now), **we do not think the exact timing of an announcement is so important by now**. In other words, we think it is unlikely that we will see a repetition of taper tantrum, where investors were caught by surprise, and the economy was in a very different place from now. **The tapering *pace* will be much more important.** Will it take three, six, nine or 12 months? **We expect the Fed to taper by USD20bn per meeting, implying that tapering is concluded at the July 2022 meeting. Tapering will, however, be flexible so the pace can be increased/slowed if needed.**

The reason why the tapering pace is so important is that it will give us an idea of when the Fed may start hiking, as the Fed has made it clear that it would like to conclude tapering before hiking the Fed funds rate.

In connection with the meeting, we also get updated projections, where we will be looking for whether the Fed will start signalling one rate hike next year. Just two more FOMC members need to signal one rate hike next year for the median dot to change from no rates hikes to one rate hike. **Given inflation remains high and inflation expectations are rising, we expect the Fed to signal one rate hike next year.**

Fed dots vs current market pricing



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

Fixed Income: Little impact on US yields – risks skewed to the upside

If our close-to-consensus view materialize the imminent market reaction should be muted in the US fixed income market. However, we see the risk tilted in direction of higher yields as the FOMC most likely will be keen to underline that a tapering announcement has only been postponed and not cancelled. Especially, the money market will pay attention to the dots. If we are right about the Fed raising the dots, the market might move the timing of the first rate hike forward in time. It is currently priced late Q1 2023. We also note that positioning now seems more neutral in the US treasury market. The recent disappointing numbers have only pushed yields marginally lower indicating a more neutral positioning compared to April-July where 10Y US yields dropped close to 50bp.

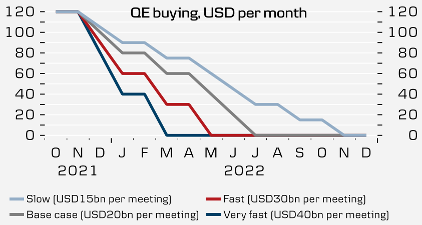
We continue to see upside for 10Y US treasury yields in 2022 and have a 12 month forecast of 2.0%.

FX: EUR/USD still set to move lower

For the Dollar, the key remains that tapering is being viewed as a 'done deal' in the sense that it will be coming by Q4. Amid this, it appears that global growth is slowing. Surveys also indicate that investor interest in Europe has been declining and sentiment is shifting towards dollar. **In effect, the continued push towards tighter global liquidity conditions (Chinese deleveraging, ECB fading PEPP and Fed tapering), slower growth amid inflation uncertainty but where Fed seems reactive to the latter will likely add up to dollar strength too.** In part, this is driven by rising global uncertainty and weakness in equities; and in part, the stronger dollar is driven by economic and monetary divergence between US and the World, as well as market's view on Europe.

We view Fed's push to tighten in light of these trends and continue to see downside risk to EUR/USD over the coming year, targeting 1.15 in 12M, 1.13 in 15M.

Possible tapering paths – we expect the Fed to reduce bond buying by USD20bn per meeting, which would mean tapering is concluded in July



Sources: Federal Reserve, Macrobond Financial, Danske Bank illustration

Our Fed call summarised

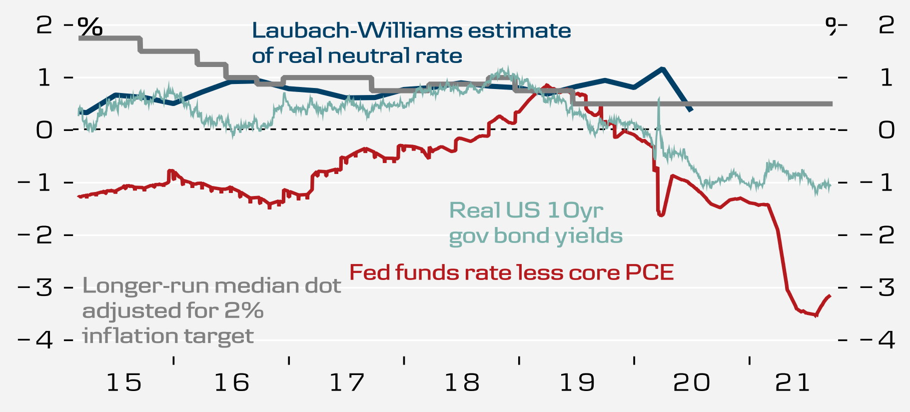
As expected, Fed Chair Powell did not provide any details on tapering in connection with Jackson Hole, but after the weak jobs report for August and NY Fed President John William's speech an announcement also seems unlikely at the upcoming meeting. We think more details are postponed until November and that actual tapering will start in December. We expect the Fed to taper by USD20bn per meeting implying that tapering will be concluded in July 2022. Just like after the financial crisis, the tapering process will be flexible in the sense that the tapering path will not be pre-determined but to be decided upon from meeting to meeting. This means the tapering pace can be increased/slowed depending on the economic and financial situation.

We expect the median 'dot' for next year to signal one rate hike (up from zero) in the updated projections.

We still expect the first rate hike in H2 2022, most likely either in September or in December. We expect the hiking cycle will continue in 2023.

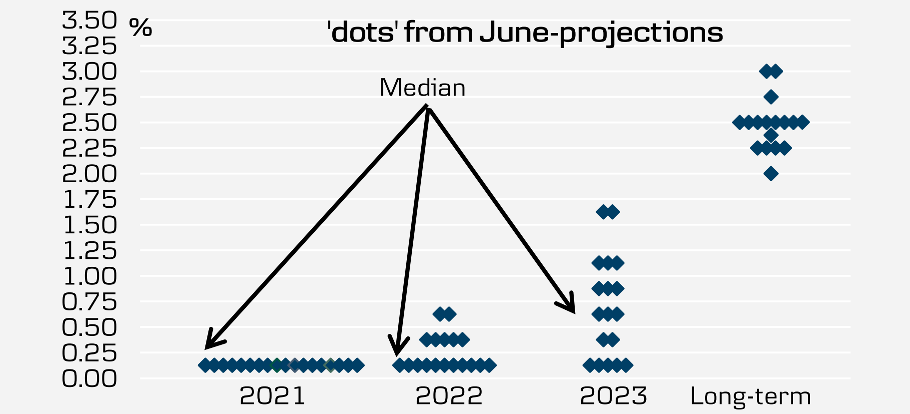
Fed charts

Monetary policy is still accommodative



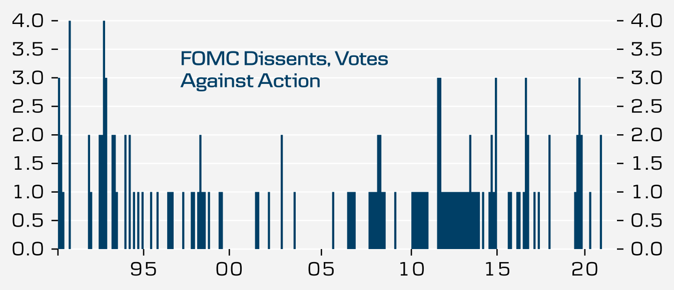
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

Fed dot plot from June



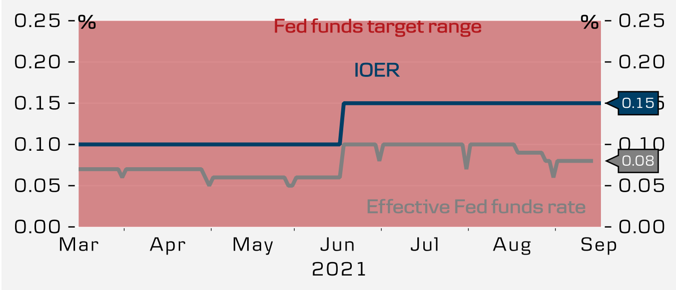
Sources: Federal Reserve, Danske Bank

The FOMC members usually work by consensus



Source: St Louis Fed, Macrobond Financial, Danske Bank

Effective Fed funds rate rose after the IOER rate hike in June

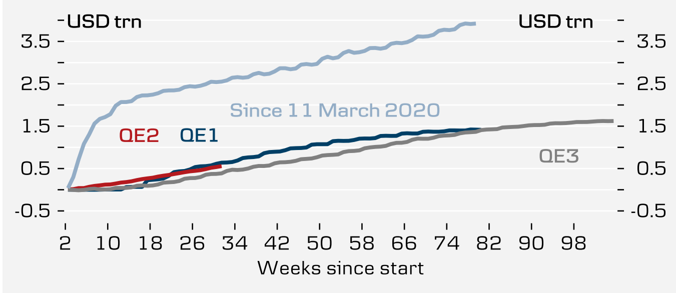


Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Macrobond Financial, Danske Bank

US balance sheet has been increasing rapidly

Source: Federal Reserve, Macrobond Financial, Danske Bank

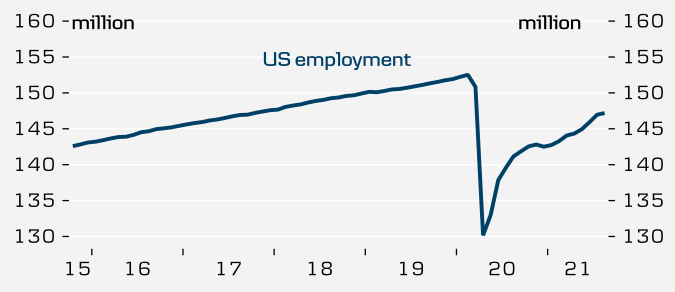
Fed is still buying USD120bn worth of bonds per month



Sources: Federal Reserve, Macrobond Financial

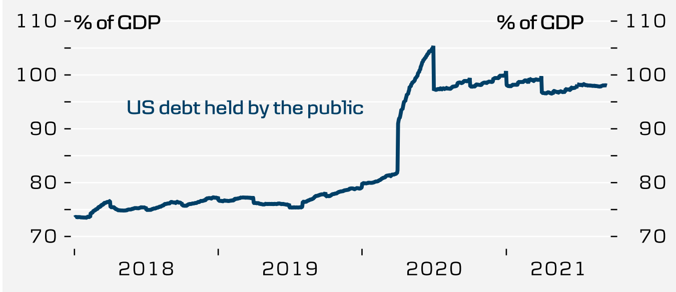
Macro charts

Employment remains significantly below pre-corona levels but jobs indicators are overall strong



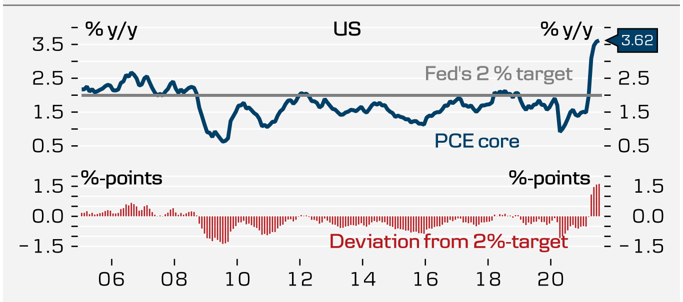
Source: BLS, Macrobond Financial, Danske Bank

US debt to increase further



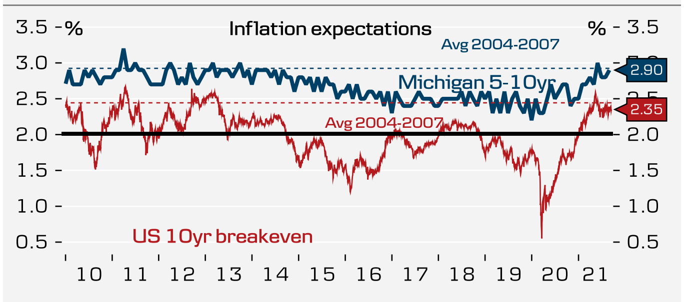
Sources: US Treasury, Federal Reserve, Macrobond Financial

PCE core inflation has moved sharply higher but the Fed expects it to moderate



Source: BEA, Macrobond Financial, Danske Bank

Inflation expectations have risen since 2020 but remain well-anchored



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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