

Fed Research

Review: Slowly taking the foot off the gas

Key takeaways

- The Fed was more hawkish than anticipated and the Fed meeting most likely marked the first step of the Fed taking the foot off the gas.
- Fed is now signalling two rate hikes by end-2023 and that the FOMC members will continue discussing tapering at upcoming meetings.
- We have changed our Fed call now expecting the Fed to start actual tapering in Q4 21 and hike for the first time in H2 2022 (from January 2022 and Q1 23, respectively).
- FX: We think the message from FOMC and the likely path for US monetary policy support our call for a lower EUR/USD. We still forecast 1.15 in 12M.
- Fixed Income: Fed message adds more upside to UST yields. We believe that the risk is still tilted to the upside over the coming quarter and continue to see 10Y UST at 2.0% year-end. However, we should probably see an actual improvement in the labour market and a more firm discussion on tapering before we see a move to the 1.75-2.00% range

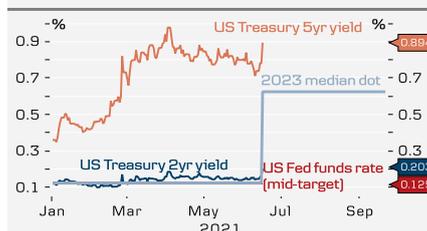
The Fed was more hawkish than anticipated

As expected the Fed kept the Fed funds target range and the bond buying pace unchanged at 0.00-0.25% and USD120bn per month, respectively. The Interest Rate on Excess Reserves was raised by 5bp to 15bp from 10bp.

We were wrong thinking that this Fed meeting would not be a significant one (and so were market participants), as the Fed was more hawkish than expected. The median Fed dot now signals two rate hikes by 2023 (we expected the Fed to signal one) and seven out of 18 FOMC members signal at least one rate hike already next year. Hence, this meeting was likely the first step in the Fed taking the foot off the gas, assuming that equities and inflation expectations hold up and jobs growth strengthens.

The main reason is not that actual inflation has moved higher, as the Fed repeats that it is “largely reflecting transitory factors” (base effects, re-opening and bottlenecks), although Fed Chair Jerome Powell acknowledged that risk is that high inflation may turn out to be more persistent than what the Fed anticipates right now. One reason that the Fed remains calm on inflation is due to still well-anchored inflation expectations. Long-term inflation expectations have risen but they are just back to the levels prevailing before we talked about central banks struggling with too low inflation and the effective lower bound. The Fed’s main theory on inflation is that actual inflation is driven by inflation expectations in the long-run (something that we agree on) and they are not signalling that inflation will spin out of control and remain very high. We discussed in further details in *Research US: Higher inflation but not spinning out of control due to still well-behaved expectations*, 14 June.

Large jump in US 5yr Treasury yields



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

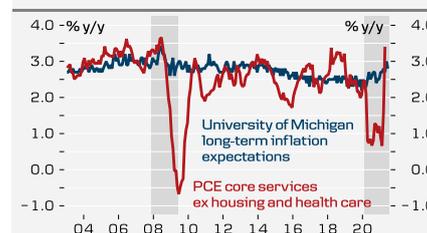
Sources: Federal Reserve, Bloomberg, Macrobond Financial

More hawkish Fed due to strong labour market indicators



Sources: JOLTS, Macrobond financial

Fed not overly concerned about high inflation due to well-anchored expectations



Sources: BEA, 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 Merklén
+45 45 12 85 18
lsm@danskebank.dk

Instead, the reason is the development in the labour market. Nonfarm payrolls have been lower than anticipated but many labour market indicators have been quite strong. Fed Chair Powell said that he is confident that *“we are on path to a very strong labour market recovery”* highlighting that temporary factors are keeping employment growth low. Job openings are record-high, Americans think it is easy to find jobs, businesses find it difficult to find qualified workers, there are more voluntary quits etc. **Most indicators suggest that as soon as the temporarily higher unemployment benefits expire (on 6 September at the latest, in some states even earlier), employment will increase significantly.**

As expected, the Fed repeated that it will continue buying bonds at the current pace “until substantial further progress has been made”. Still, also as expected, Fed Chair Powell said in his introductory statement that the FOMC members had a discussion on tapering at the meeting, revealing that the Fed has started “talking about talking about tapering”, as we wrote in our preview *Fed Research Preview: Start talking about talking about tapering?*, 14 June. **The Fed will continue to discuss “progress” in economic data in coming meetings. Powell emphasised that they are going to pre-announce tapering well in advance.**

There are plenty of Fed speeches next week and we are looking forward to hear from individual FOMC members how they see the economy and monetary policy going forward to get a better idea of what each member thinks.

New Fed call

We change our Fed call based on the FOMC meeting and our updated inflation forecasts (see *Research US: Higher inflation but not spinning out of control due to still well-behaved expectations*, 14 June).

We now expect the Fed to turn more and more hawkish in coming months so that actual tapering starting will start in Q4 21 (previously in January 2022). We are not surprised if the tapering is faster in mortgage-backed securities than treasuries given the development in the housing market. We expect tapering is concluded in summer 2022 (previously September 2022).

We expect the first rate hike in H 2022 (previously Q1 2023).

Overall, we see a road from here with tapering, rate hikes and a mild liquidity tightening in coming years.

FX: FOMC supports our view of a stronger dollar in H2

We expected Powell to be hawkish at yesterday’s FOMC meeting but he overdid our expectations. In line with this, **EUR/USD dropped from somewhat above 1.21 to 1.20 which is a large drop on a single event and probably goes to show that markets were not expecting this.** Nonetheless, equities firmed over the meeting which suggest a more hawkish Fed might not immediately be an issue for broader risk sentiment. Notably, Powell said this was indeed the meeting where ‘talking about talking about tapering’ had happened and he repeated a forward looking statement in regards to a likely ‘very strong recovery in the labour market’. The Fed has repeatedly been unwilling to say such. Hence, a shift in forecasting rate hikes but the choice of words and rhetoric was quite hawkish when put together.

Over the coming months, we continue to expect a moderation in the pace of expansion in the manufacturing sector (declining PMIs) and a shift towards dollar amid a slight tapering of cross asset inflation momentum. **In our view, such macro & financial outcomes will involve downside pressure for EUR/USD from its currently elevated level and we continue to forecast 1.19 in 3M, 1.15 in 12M. The exact timing of cause remains highly**

dependent on the state of US labour market, risk sentiment and incoming macro data but the message from FOMC clearly is in line with our expected path for EUR/USD spot.

Fixed Income: Fed message adds more upside to UST yields

The change in the 'dots', the overall more optimistic message from Powell regarding the labour market and the comment that the Fed had a discussion on "progress" related to tapering weighed especially on the policy sensitive 5y point on the UST curve. 5y UST yields jumped more than 12bp right after the announcement and the curve flatten 5s10s and steepened 2s5s. Yields retraced slightly as Powell tried to talk down any discussion about 'lift off' in respect of rate hikes.

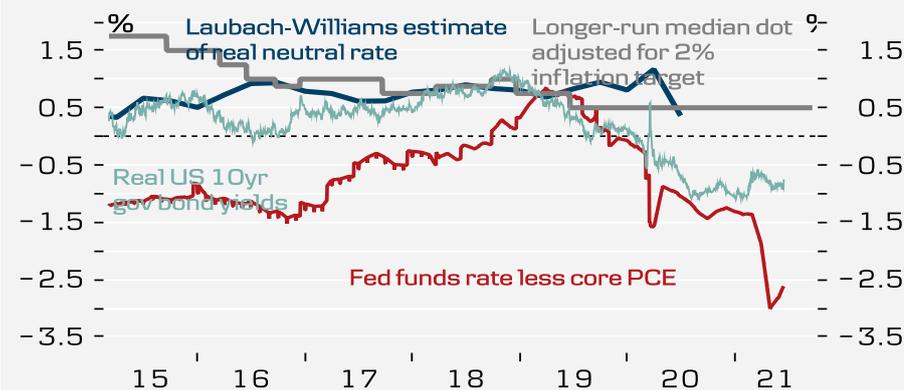
The market reaction in the bond market underlines first and foremost the change in rhetoric, but also that market positioning was more neutral going into the meeting compared to last week, when the higher than expected CPI data resulted in a noteworthy move lower in yields, as the market apparently was heavily positioned for higher yields.

We believe that the risk is still tilted to the upside over the coming quarter and continue to see 10Y UST at 2.0% year-end. However, we should probably see an actual improvement in the labour market and a more firm discussion on tapering before we see a move to the 1.75-2.00% range. But the message today could potentially trigger a small 'taper tantrum' the next couple of months, though it is not our main scenario.

The FOMC also made a technical change to the IOER that was hiked by 5bp to 0.15% and the reverse repo rate that was hiked by 5bp to 0.05%. **The change in the IOER is done to secure that the fed funds rate stays in the 0-0.25% range given the surging liquidity in the market.** The change in the reverse repo rate should help especially money market funds that recently have 'parked' around USD500 billion overnight at the zero rate in lack of positive yielding alternatives.

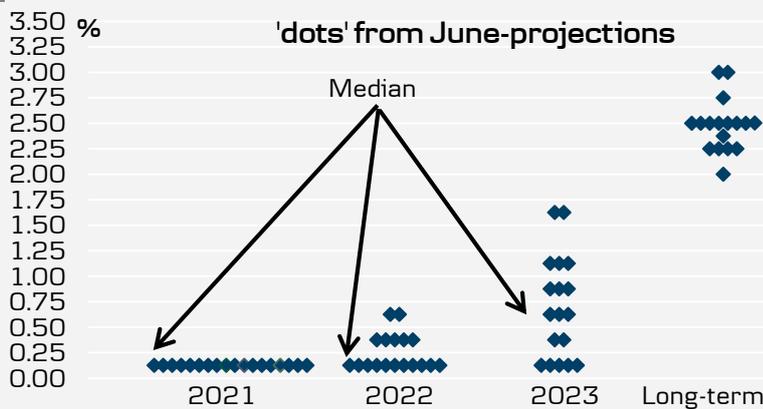
Fed charts

Monetary policy is still accommodative



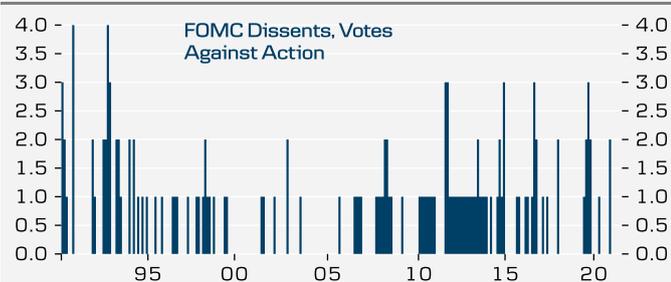
Note: Past performance is not a reliable indicator of current or future results.
 Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

New Fed dot plot



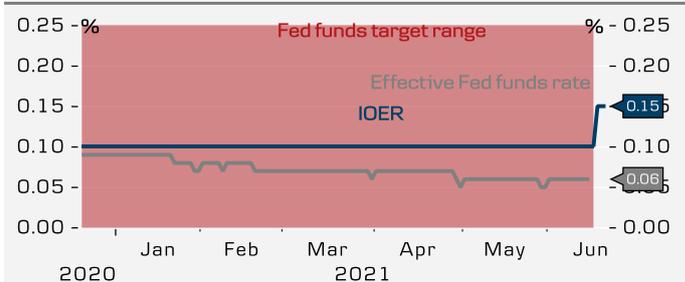
Sources: Federal Reserve, Danske Bank

The FOMC members usually work by consensus



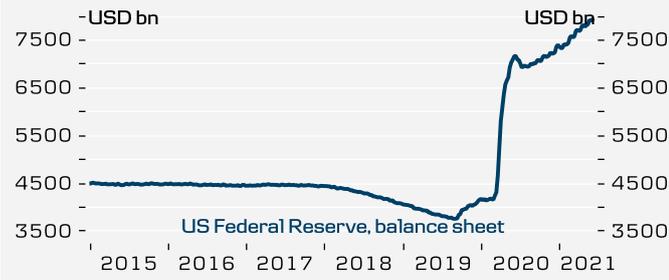
Source: St Louis Fed, Macrobond Financial, Danske Bank

The Fed hiked the IOER rate to get the effective Fed funds rate closer to the mid of the target range (0.00-0.25%)



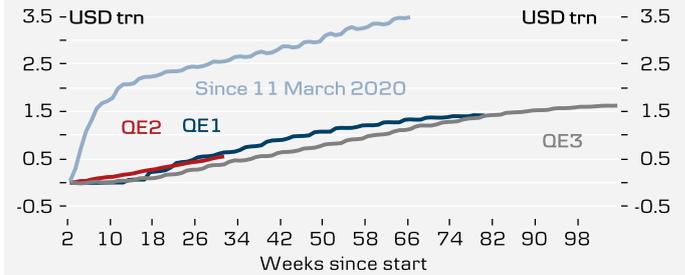
Note: Past performance is not a reliable indicator of current or future results.
 Source: Federal Reserve, Macrobond Financial, Danske Bank

US balance sheet has been increasing rapidly



Source: Federal Reserve, Macrobond Financial, Danske Bank

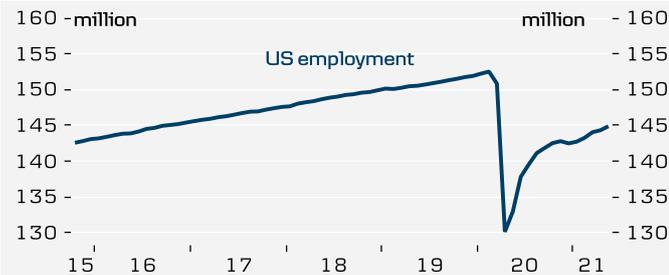
Fed still buying USD120bn worth of bonds per month



Sources: Federal Reserve, Macrobond Financial

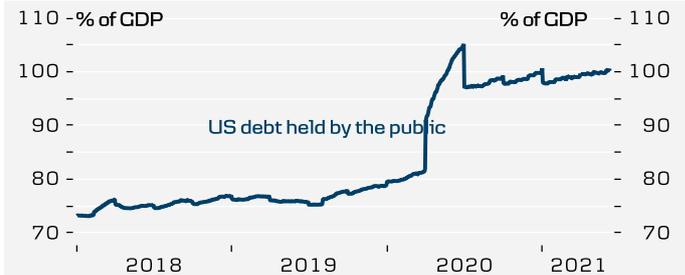
Macro charts

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



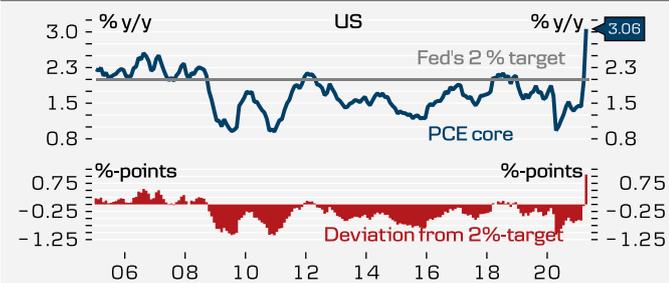
Source: BLS, Macrobond Financial, Danske Bank

US debt to increase further



Sources: US Treasury, Federal Reserve, Macrobond Financial

PCE core inflation has moved sharply higher but the Fed expects it mostly reflects transitory factors



Source: BEA, Macrobond Financial, Danske Bank

Inflation expectations are 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

Disclosures

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.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issues covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Ad hoc.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) [('Relevant Financial Instruments').]

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank A/S's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank A/S is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank A/S who have prepared this research report are not registered or qualified as research analysts with the New York Stock Exchange or Financial Industry Regulatory Authority but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

Report completed: 16 June 2021, 22:27 CEST

Report first disseminated: 16 June 2021, 22:30 CEST