21 March 2018

FOMC review

Only slightly steeper rate path due to Trumponomics

- **The Fed maintained the three rate hikes signal for this year (close call between three and four) and revised the signal for next year up to three hikes, as expected.**
- **We still expect the Fed to hike twice more this year but risk is skewed towards a third. We expect three hikes next year. While market pricing for this year seems fair, markets are still pricing the Fed too softly next year, in our view.**
- **The Fed hike is not set to trigger a new course for the dollar, and we still see EUR/USD in the 1.21-1.26 range near term**.

Fed maintains three hikes signal for 2018

As expected by everyone, the Fed raised the target range by 25bp to 1.50-1.75%. More interestingly, the **Fed maintained the three rate hikes signal for this year**, in line with our expectation laid out in our preview, although it was **close between three and four hikes** (see chart to the bottom-right). This is important given that some of the most outspoken doves like Bullard, Evans and Kashkari are not voting this year. This supports the view that **risk is probably skewed towards a total of four hikes this year**. Still this was interpreted dovishly with EUR/USD moving higher and US yields lower. Also in line with our expectation, the **2019 dot was raised from slightly more than two hikes to three hikes,** taking the Fed funds target range to 2.75%-3.00% by year-end 2019. The Fed now expects the target range to rise 50bp above the natural rate of interest (the rate where monetary policy neither expansionary nor contractionary) by year-end 2020. The reason for the move up in dots is mainly the more expansionary fiscal policy under Trump. We still believe the overall policy mix is going to be more expansionary, as the Fed seems reluctant to offset more expansionary fiscal policy 1:1.

We still expect the Fed to hike twice more this year (June and December) and three times next year (March, June, September). However, the timing of the rate hikes may also depend on whether Powell decides to make every meeting live by having a press conference at every meeting instead of every other. Indeed, it would make it easier for the Fed to spread out the rate hikes (if the number of hikes is uneven).

As expected, there were no major changes to the statement. The Fed repeated risks are *"roughly balanced"*, it still monitors inflation *"closely"* and that it expects *"further gradual increases"* in the target range. The most important change was that it now says that *"the economic outlook has strengthened in recent months"*.

Powell said very explicitly the Fed is not about to alter its plan to shrink the balance sheet (unless the outlook deteriorates) and it still has not decided what the appropriate target is. Ultimately, it depends on the demand for the Fed's liabilities (public demand for currencies and banks' demand for high quality liquid assets due to regulation).

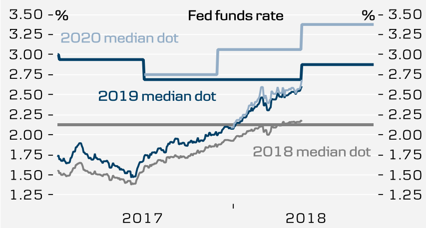
The Fed discussed trade policy but FOMC members have not changed their economic outlook on back of this. We would likely need to see an escalation of the trade war before that is going to happen. **There was no question on the higher LIBOR/OIS spread, so we do not know what the Fed might think about the large increases.**

Recent US research

FOMC Preview: Sticking to three rate hikes signal for 2018, 16 March

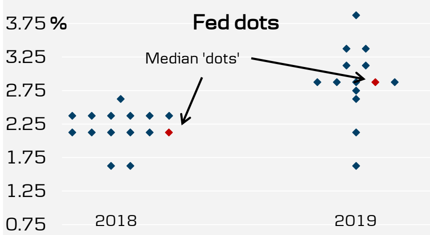
Research US: Symbolic protectionism with limited impact on growth and inflation but risks remain, 7 March

Markets still priced too soft next year



Source: Federal Reserve, Bloomberg, Danske Bank, Macrobond Financial

Median dots signal two more hikes this year but close call!



Source: Federal Reserve, Danske Bank

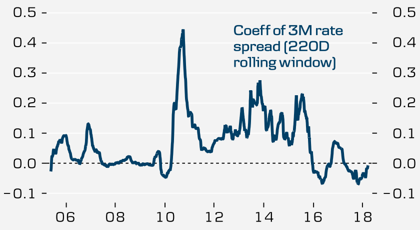
Senior Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

Chief Analyst
Christin Tuxen
+45 45 13 78 67
tux@danskebank.dk

FX: dovish Fed hike does not steer new course for EUR/USD

EUR/USD back above 1.23 as Fed delivered a 'dovish hike', largely in the way we had expected. While the risk of a fourth hike remains and the somewhat steeper rate path hinted at by the dots suggests potential for USD support from higher US rates further out, the market is not ready for pricing this just yet. Also, we continue to stress that short-term rates are not a key driver of EUR/USD at present. As we wrote in *FX Strategy - EUR/USD risks more two-sided over shorter horizons,* **EUR/USD has been largely unmoved by notably the recent uptick in Libor rates as the short-rate spread fails to set a course for the pair**. This hints that the Fed needs to change its course on policy more dramatically for it to impact USD crosses. Rather, we stress that the risk of USD support over shorter horizons from an uptick in US real yields as the issuance of US Treasuries gains traction is a crucial one to watch going forward. **In sum, we expect the March hike will not trigger a new course for the dollar, and we still see EUR/USD in the 1.21-1.26 range near term** with focus again set to shift to the Trump administration's next step on protectionist measures.

Short-term rate spread is not a key driver of EUR/USD spot at present



Source: Macrobond, Danske Bank

Note: coefficient of 3M rate spread in (adjusted version of) our Short-Term Financial Model for EUR/USD.

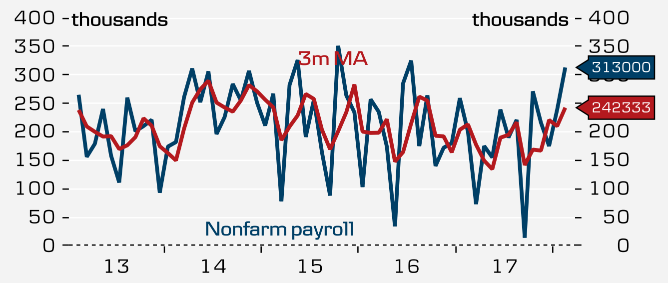
No major changes to the FOMC statement

Subject	Comments	Direction
Growth	"The economic outlook has strengthened in recent months"	Hawkish
Labour market	"Job gains have been strong in recent months, and the unemployment rate has stayed low"	Unchanged
Inflation	Inflation "[...] is expected to move up in coming months"	Unchanged
Inflation expectations	Market-based measures "have increased but remain low"; survey-based measures "are little changed, on balance":	Unchanged
Balance of risks	"Near-term risks to the economic outlook appear roughly balanced"	Unchanged
Policy bias	"[...] further gradual increases in the fedeal funds rate" but "likely to remain, for some time, below levels that are expected to prevail in the longer-run".	Unchanged
Median 'dots'	2 more hikes in 2018, 3 in 2019, 2 in 2020, 2.875% long-run	Revised up

Source: Federal Reserve

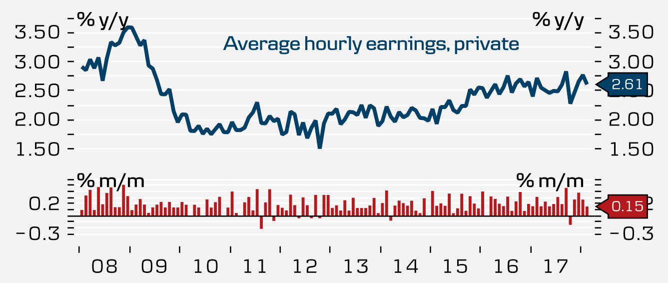
Charts

Strong employment growth



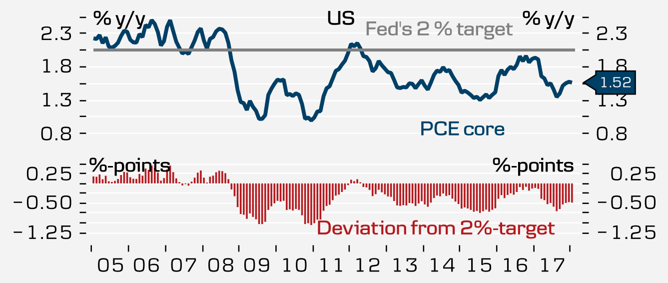
Source: BLS, Macrobond Financial

Wage growth remains subdued



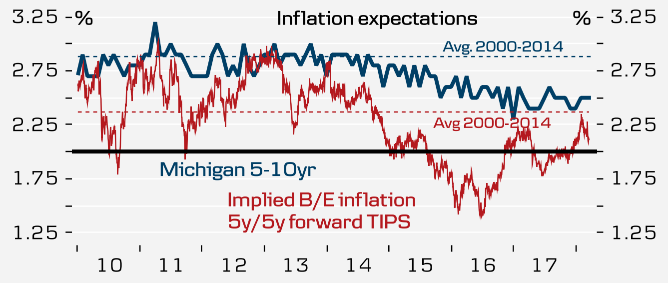
Source: BLS, Macrobond Financial

Core inflation still below 2% target



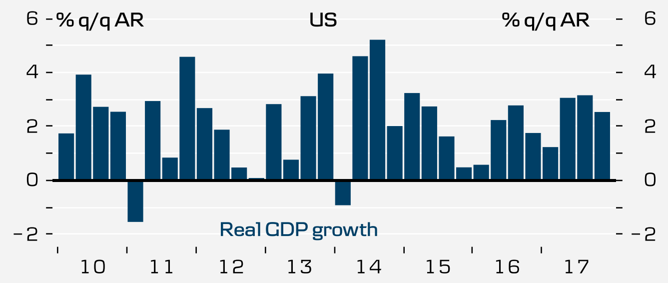
Source: BEA, Macrobond Financial

Market-based inflation expectations not far from historical average anymore



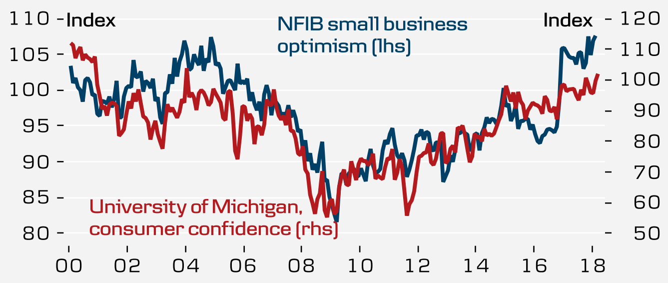
Source: Michigan, Bloomberg, Macrobond Financial

Strong GDP growth the last three quarters



Source: BEA, Macrobond Financial

Very high optimism suggests the expansion continues



Source: NFIB, University of Michigan, Macrobond Financial

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Mikael Olai Milhøj, Senior Analyst, and Christin Kyrme Tuxen, Chief 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 issuers 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

None.

Date of first publication

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

General disclaimer

This research report has been prepared by Danske Bank (a division of Danske Bank A/S). It is provided for informational purposes only. 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').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, 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 responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank 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 herein.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

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'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/A, 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 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 who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA 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.

Report completed: 21 March 2018, 21:05 CET

Report first disseminated: 21 March 2018, 21:50 CET