27 July 2016

FOMC preview

Fed leaves the door ajar for a hike later this year, perhaps already in September

Fed says near-term risks have diminished

As expected FOMC maintained the federal funds target range unchanged at 0.25%-0.50%. Compared to the last meeting when the decision was unanimous, Fed's George dissented by voting for a Fed hike. As this was one of the small meetings without updated 'dots' and a press conference, focus was on the statement.

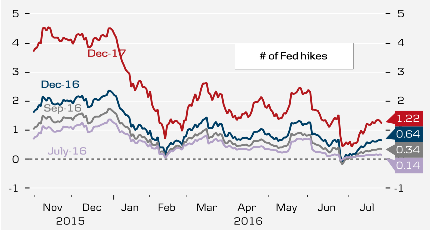
As expected the FOMC recognised that the economy grew at a moderate pace in Q2 (especially due to strong consumer spending) and employment growth rebounded in June after the slowdown in April and May. Also FOMC repeated that it *'continues to closely monitor inflation indicators and global economic and financial developments'* as expected. **A new sentence attracted a lot of attention as the FOMC stated that *'near-term risks to the economic outlook have diminished'*, meaning that the statement is more hawkish than the statement in June despite the UK voting to leave the EU just a week after the June FOMC meeting**. Unfortunately FOMC statements are not very detailed and we have to wait until the minutes or upcoming Fed speeches to get more information about how the Fed sees the world. Although we expected risk to be tilted towards a more hawkish Fed, we had expected the FOMC to stay cautious due to Brexit as the minutes from the last FOMC meeting stated that the Fed would have to *'wait for additional [...] information that would allow them to assess the consequences of the U.K. vote for global financial conditions and the U.S. economic outlook'*. **With the inclusion of this sentence, FOMC leaves the door ajar for a hike later this year, perhaps already in September.**

We do not know the impact of Brexit yet

Despite the more hawkish FOMC statement, we maintain our call that Fed is on hold for the rest of the year. We still expect the Fed to be on hold until June 2017 and only hike twice next year (following hike in December 2017). **However, given the slightly more hawkish Fed, the Fed hiking theme could return for real, if post-Brexit US data stay strong**. There have only been a few post-Brexit data releases, so it is still too early for the Fed to conclude that the US is unaffected by Brexit. Our main scenario is that economic activity will be lower in the coming months leaving the Fed on hold. Also, some of the recovery in the financial markets since Brexit has been driven by the expectations of more dovish central banks, as markets among other things have priced out Fed hikes. So if the Fed begins to talk about hikes again soon, markets could respond negatively, which could eventually lead to the Fed postponing again. Since PCE core inflation is still below 2%, inflation expectations have fallen and wage inflation is still subdued, the Fed can afford to stay patient. **Markets price in around 34% probability of a hike in September and around 64% probability of a hike by year-end.**

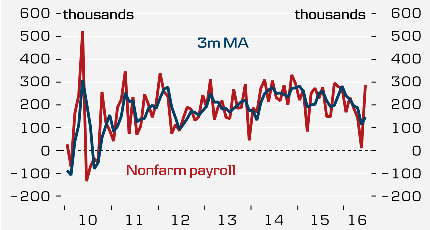
US money market rates have recently moved higher after the recent strong numbers and as the US money market reform is moving closer. **The message from the FOMC tonight acknowledging the better labour market numbers could reinforce the tendency for higher money-market rates as pricing of rate hikes is still very modest for 2016-18. The incoming data will decide whether the market will price a more significant probability of a September hike.** The global hunt for yield is still keeping a lid on longer-dated treasury yields and a further flattening of the 2Y10Y is still in the cards for the next couple of months.

Pricing still soft despite more hawkish Fed



Source: Bloomberg

Fed recognises rebound in employment



Source: BLS

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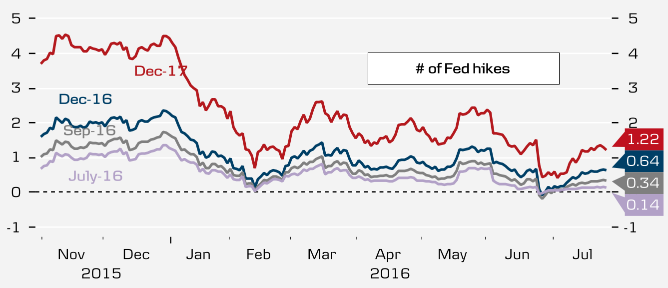
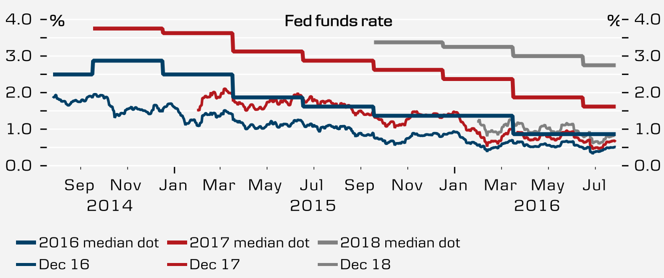
FOMC chart book (continues on the next pages)

Market pricing still soft



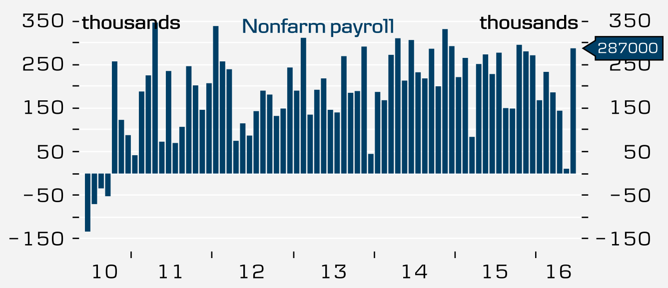
Source: Bloomberg

Market pricing much softer than 'dots' signal



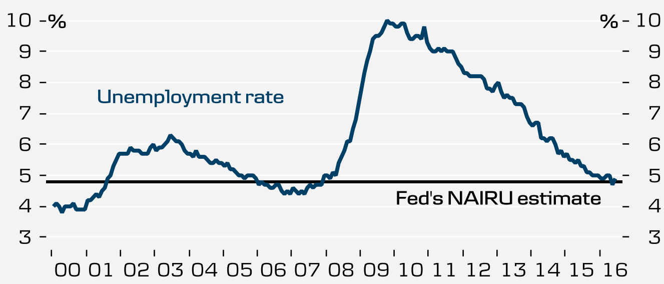
Source: Federal Reserve, Bloomberg

Employment rebounded in June after slowdown in April and May



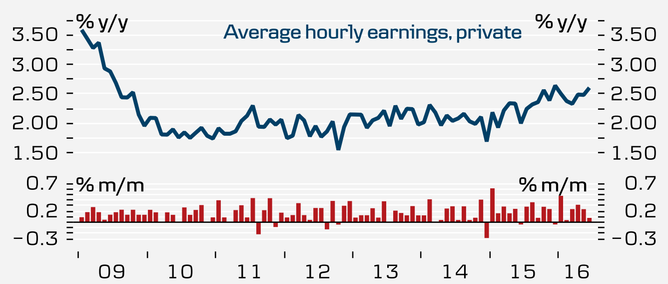
Source: BLS, Danske Bank Markets

Unemployment rate around Fed's NAIRU estimate



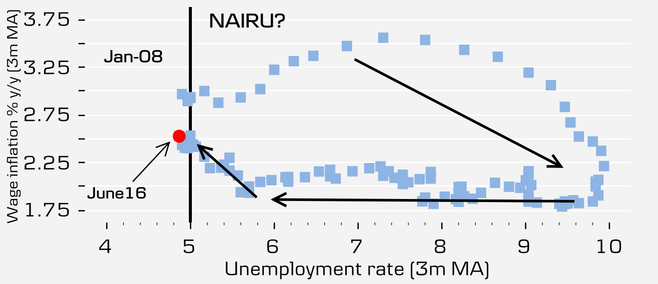
Source: BLS, Danske Bank Markets

Wage inflation is trending up but still subdued



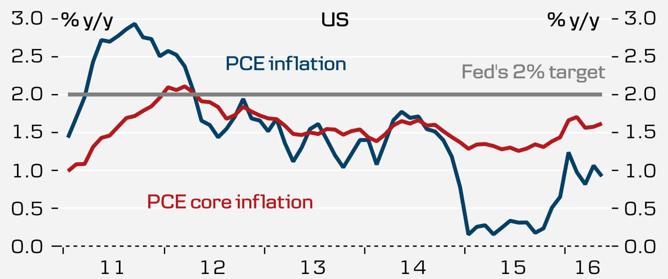
Source: BLS, Danske Bank Markets

The Fed sees the world through the Phillips curve



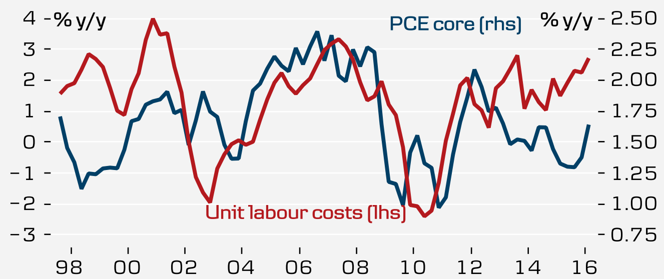
Source: BLS, Danske Bank Markets

PCE core inflation still below target



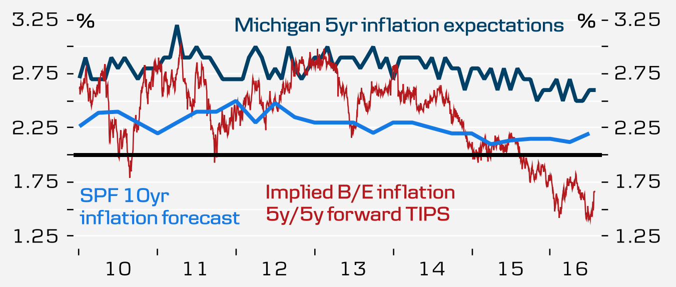
Source: BEA

Unit labour costs indicate higher inflation



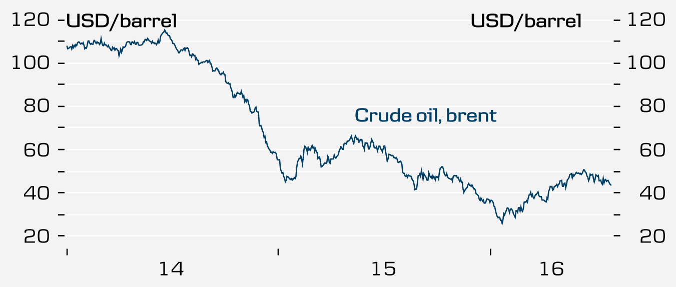
Source: BEA, BLS

Fed a bit concerned about low inflation expectations



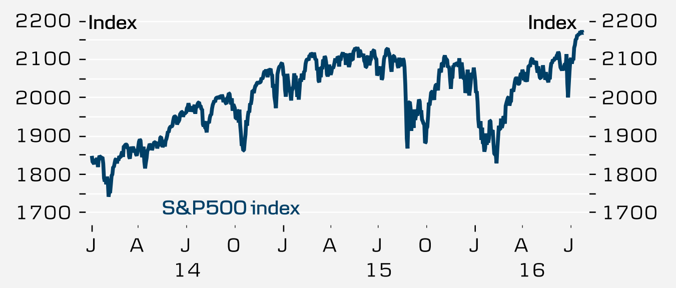
Source: Federal Reserve of Philadelphia, Macrobond Financial, University of Michigan, Danske Bank Markets

Oil price has fallen recently but still higher than in the beginning of the year



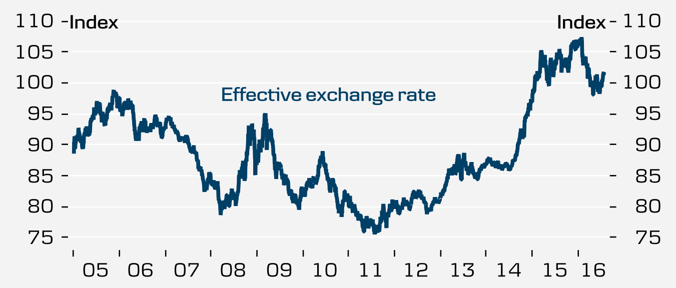
Source: EIA

US equities have recovered after Brexit



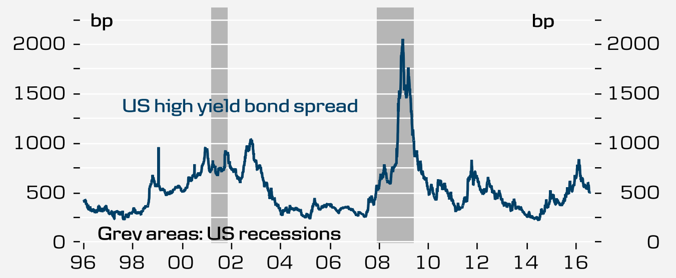
Source: Macrobond Financial

USD has weakened but still relatively strong



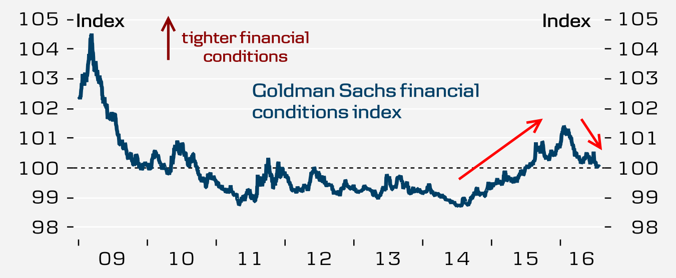
Source: Federal Reserve of Philadelphia, Macrobond Financial, University of Michigan, Danske Bank Markets

Credit spreads have declined but still large



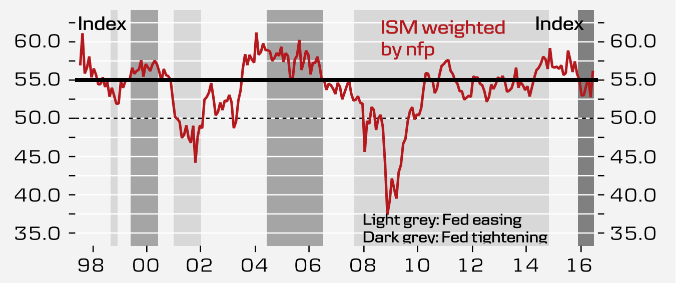
Source: Bloomberg

Financial conditions have eased compared to early 2016



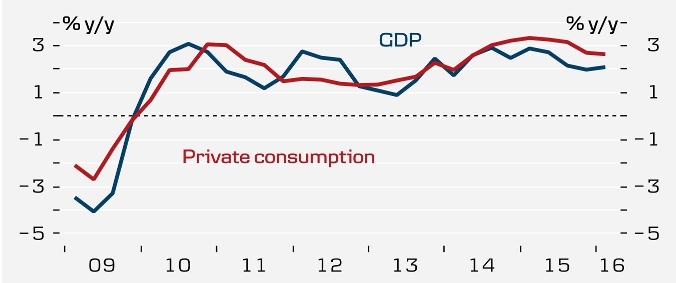
Source: Goldman Sachs, Federal Reserve, Danske Bank Markets

ISM indices have rebounded



Note: Dark (light) shading indicates periods of tightening (easing)
Source: ISM, Danske Bank Markets

Private consumption the main growth driver



Source: BEA

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This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The authors of the research report are Mikael Olai Milhøj, Senior Analyst; Thomas Harr, Global Head of FICC Research; and Arne Lohmann Rasmussen, Chief Analyst.

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