

FOMC Preview

No major changes

- **We expect the Fed to maintain the Fed funds target range at 1.00-1.25% at this week's meeting**, in line with consensus and market pricing. As it is one of the small meetings, all eyes are on the statement, as there are no updated projections and no press conference.
- Given the Fed seems to act only at the big meetings, **we think the Fed will wait until September to make an announcement on 'quantitative tightening'**, despite many FOMC members thinking they should get going 'relatively soon'.
- **We do not think there will be major changes to the FOMC statement, although it is likely the probability is skewed towards a slightly more dovish tone given inflation has now been weaker than expected for four consecutive months.** Based on Janet Yellen's recent testimony to US congress, the Fed still has faith in the Phillips curve, i.e. the tighter labour market will push wage growth and thus underlying inflation higher eventually. However, in our view, the jobs report for June highlighted the Fed's dilemma (see *Flash Comment US: Fed's dilemma*, 7 July).
- **Due to the Fed's strong belief in the Phillips curve and given we expect further tightening of the labour market, we think the Fed will hike one more time this year in December.** We still think risks are skewed towards the Fed pausing its hiking cycle due to low inflation, which may not be just 'transitory' given the low inflation expectations. In our view, the problem is that the tightness of the labour market is not the only factor determining wage growth, as second-round effects after many years with low inflation have hit wage growth. When employees expect inflation to remain low, they can live with low wage growth, as real wage growth may still be solid, making it less likely inflation will reach the target (see also *Strategy: Central banks consider leaving the party*, 30 June). In this regard, it is interesting that four FOMC members indicated that they do not expect the Fed to hike more this year in the June projections. Consensus is for another hike this year, while markets price in a coin flip.
- EUR/USD has gained significantly over the past month, as both ECB communications and the balance of political risks have shifted in favour of the euro. In our view, Mario Draghi and the ECB have already let EUR/USD out of the bottle – and basically paved the way for a continued correction in the FX market of some of the long-standing undervaluation in EUR/USD. See *FX Strategy: ECB has let EUR/USD out of the bottle* (29 June) for details. We expect these dynamics to remain key drivers for the cross in the near term, while relative rates (FOCM pricing) are likely to matter less (this was also evident last week when EUR/USD continued higher post the ECB's press conference despite EUR interest rates trading lower). Fundamentally, EUR/USD is still undervalued and we still see the case for a higher EUR/USD six to 12 months ahead. **We are currently reviewing our EUR/USD forecast, stressing that we see risks skewed mainly on the upside relative to our 6M and 12M targets of 1.15 and 1.18, respectively.**

Recent US research

Flash Comment US: Fed's dilemma, 7 July

FOMC Minutes: Fed likely to announce start of QT in September, 5 July

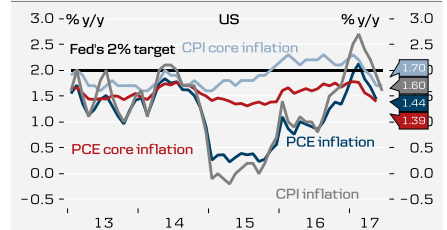
FOMC Review: Hawkish Yellen ignores inflation and economic data, 15 June

Fed's Quantitative Tightening Details: Impact on the balance sheet and reinvestments, 19 June

Fed's 'Quantitative Tightening': Fixed income implications, 6 April

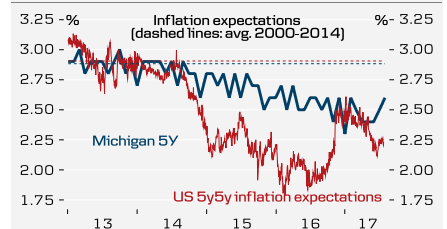
Research US: Fed's regulatory hurdle for starting quantitative tightening, 13 March

All inflation rate measures below 2%



Source: BEA, BLS

Inflation expectations are significantly below historical averages

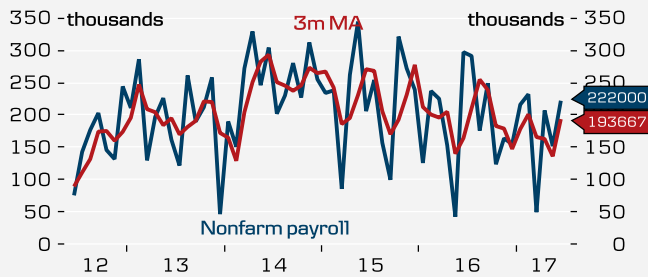


Source: Michigan, Bloomberg

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

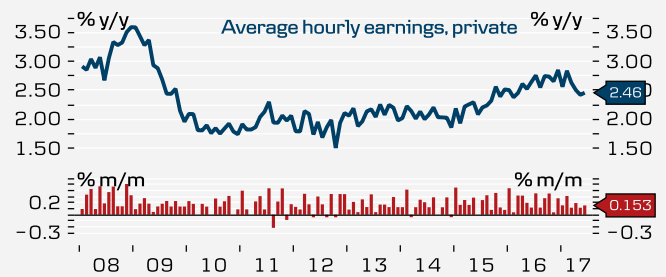
Charts

Employment growth has picked up pace again



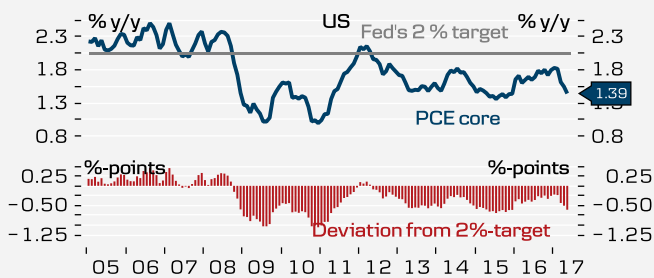
Source: BLS

Wage growth still subdued



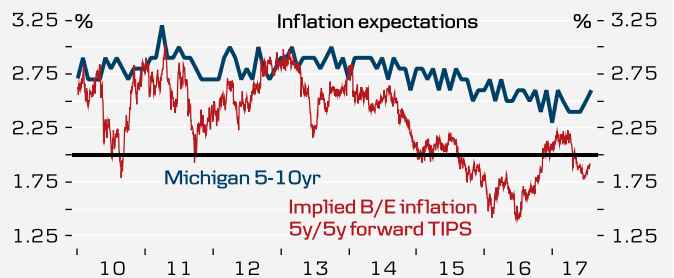
Source: BLS

Core inflation not close to 2%



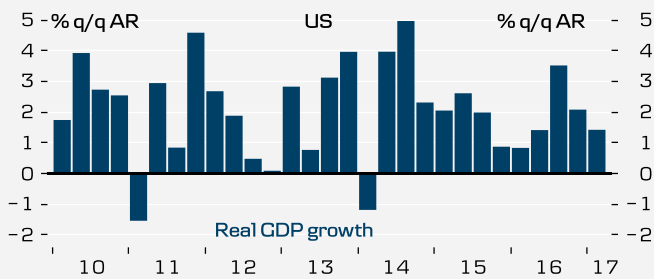
Source: BEA

Inflation expectations are low



Source: Michigan, Bloomberg

GDP growth was weak in Q1 and not as strong in Q2 as previously thought



Source: BEA

US economic data have disappointed lately



Source: Bloomberg

Disclosures

This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The author of the research report is Mikael Olai Milhøj, 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 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.

The research reports of Danske Bank 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 a 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 has been prepared by Danske Bank Markets (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 in this research report.

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/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 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: 24 July 2017, 13:45 GMT

Report first disseminated: 24 July 2017, 14:40 GMT