26 July 2017

FOMC review

Smidgen dovish but it does not alter the overall picture

- **As expected, the Fed maintained the target rate at 1.00%-1.25%.** As this was a small meeting without updated projections and a press conference, focus was solely on the statement. However, the statement was without any big changes as per usual.
- One change in the statement was that it now says that the process of unwinding the balance sheet may start *'relatively soon'* instead of *'this year'*, but in reality this was not new as it just reflects the words Fed Chair Yellen used during the press conference in June. **We think this supports our call that the Fed will make an announcement on quantitative tightening at the next meeting in September.**
- **Another change was that it now says that inflation runs below 2% instead of 'somewhat below', which was a smidgen dovish.** It is difficult to say whether it is something we should pay a lot of attention to, as we know, based on Janet Yellen's recent testimony to US congress, that 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. **Due to the Fed's strong belief in the Phillips curve and given we expect a further tightening of the labour market, we think the Fed will hike one more time this year in December.** Consensus is for another hike this year, while markets price in a 40% probability.
- However, in our view, the jobs report for June highlighted the Fed's dilemma (see *Flash Comment US: Fed's dilemma*, 7 July) and 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.
- EUR/USD initially bounced back above 1.17 and yields on US government bonds fell 3-4bp across the curve after the minor dovish twist in the FOMC statement. Over the past month, EUR/USD has indeed witnessed a kind of perfect storm with ECB communication and the balance of political risks shifting in favour of the euro, and with today´s FOMC statement, relative monetary policy should also be less of a downside risk factor for EUR/USD in the near term. **On 25 July, we revised our EUR/USD forecast higher and here we pencilled in even more upside to the cross longer term. In the near term, we target EUR/USD at 1.17 in 1-3M**, reflecting that we expect the recent level shift higher in EUR/USD to persist, while momentum is expected to ease near term amid stretched technicals, short-term valuations and positioning (IMM**). Longer term, we still expect EUR/USD to trade higher targeting 1.22 in 12 months** driven by fundamentals and less Fed-ECB divergence. See *FX Strategy: more upside for EUR/USD in store*, 25 July, for more details.

Recent US research

Flash Comment US: Fed's dilemma, 7 July

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

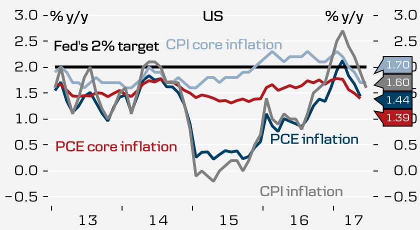
FOMC Review: Hawkish Yellen ignores inflation and economic data, 15 June

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

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

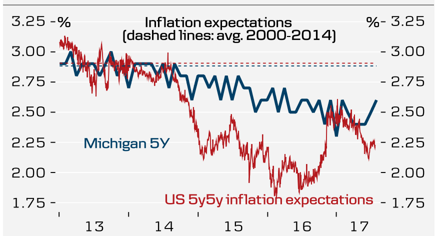
Research US: Fed's regulatory hurdle for starting quantitative tightening, 13 March

Fed now says that inflation runs below 2% and not just 'somewhat below'



Source: BEA, BLS

Inflation expectations are significantly below historical averages



Source: Michigan, Bloomberg

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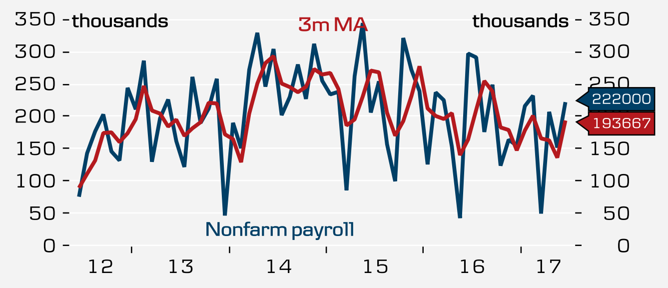
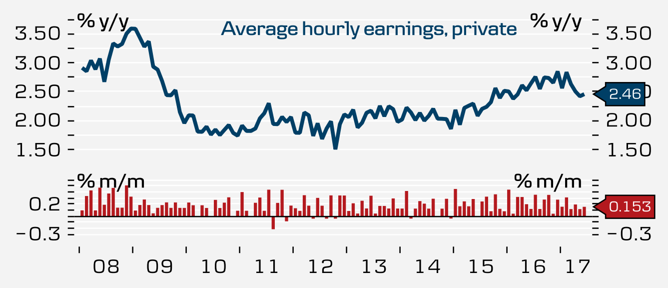
Charts

Employment growth has picked up pace again



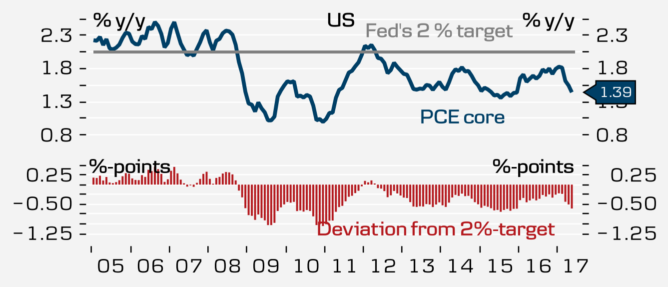
Source: BLS

Wage growth still subdued



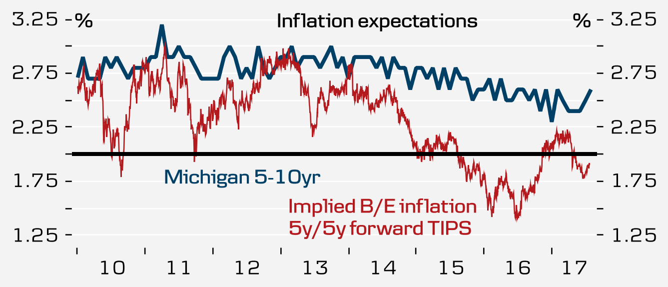
Source: BLS

Core inflation not close to 2%



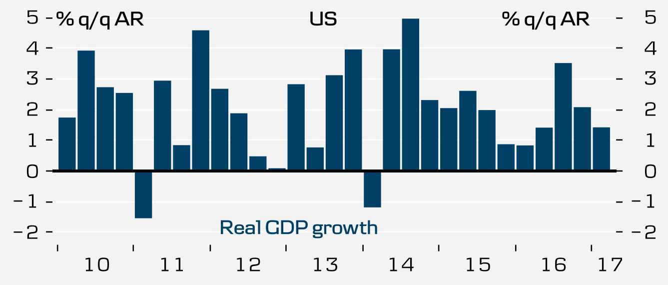
Source: BEA

Inflation expectations are low



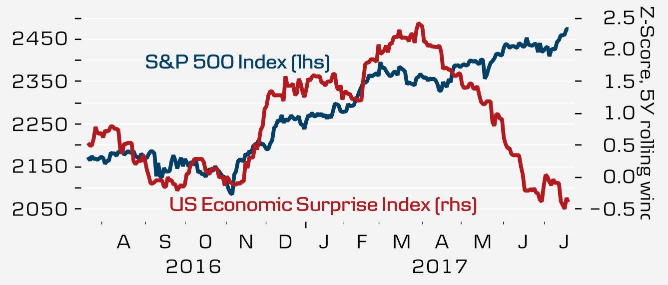
Source: Michigan, Bloomberg

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



Source: BEA

US economic data have disappointed lately



Source: Bloomberg

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Date of first publication

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