21 March 2019

FOMC review

Fed done hiking rates

Key takeaways

- **Fed no longer signals rate hikes in 2019 (down from two in December).**
- **While we now think the Fed is done hiking rates, we think it is too soon for the Fed to start cutting rates. The US economy is still in good shape, in our view.**
- **If the Fed is to hike again, we need to see market-based inflation expectations at least 13-15bp higher than the current level.**
- **Fed is ending its balance sheet runoff in September, as expected.**
- **We see limited further downside potential for the USD from the current level. Soon the market should shift its focus back to possible further ECB easing and hence we remain confident in our 1.13 forecast for EUR/USD on 3M.**

Fed outlook: hiking cycle has ended

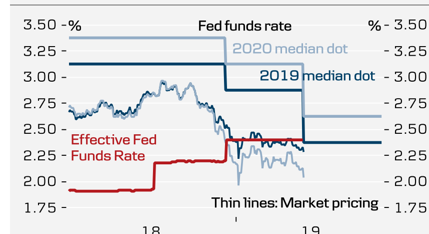
As expected by everyone, the Fed maintained the target range at 2.25-2.50%. **The biggest change to the statement is that the Fed thinks the US domestic economy has slowed** with slower private consumption and business fixed investment growth. During his press conference, Powell said he thinks the US data released so far for 2019 have been '*mixed*'. **The Fed maintains that it is best to be *'patient'*** given the *'global economic and financial developments and muted inflation pressures'*. **More surprising to us was that the 'dot plot' was lowered significantly and the median dots are now signalling no rate hikes this year and just one rate hike next year**. Five (out of 17) FOMC members think the Fed is on hold at least until year-end 2021.

Based on its dovish message, we have to admit we also misread the Fed. Our case was that a rebound in the global economy in Q2, a US-China trade agreement and a still healthy US economy would be enough to get the Fed going in June. **With the new signals, it seems like the bar is high for the Fed to move again on rate hikes.** From previous hiking cycles, we have not experienced the Fed has paused for a long time and then resumed hiking and **hence we no longer expect the Fed to hike in this hiking cycle**.

Normally that would mean that the next move from the Fed is a cut when the economic outlook deteriorates and markets have started to price in cuts already. **Talking about Fed cuts seem too early for us given the US economy is, in our view, still in fine shape.**

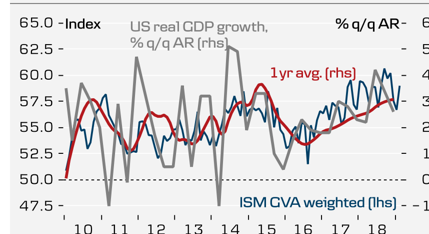
If the Fed is able to move so quickly in a dovish direction in one quarter, it may happen again in the other direction as well. The Fed only needed three weeks to make markets ready for its hike in March 2017, which is a good reminder to oneself. **One trigger for the Fed to actual hike again could be a rebound in inflation expectations given the increased focus on them**. The question is whether we need to get closer to the historical average or whether we just need to go back to the levels in 2018. Looking at market-based inflation expectations, we are only 13-15bp away from the level during most of 2018, where the Fed was not concerned about low inflation expectations.

Fed signals it is on hold in 2019



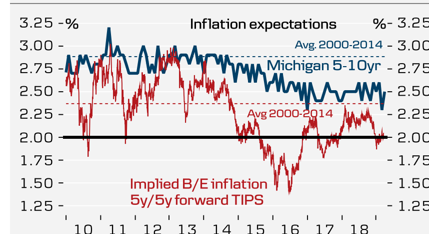
Source: Federal Reserve, Bloomberg data, Macrobond Financial

US economy still in good shape



Source: Federal Reserve, Bloomberg data, Macrobond Financial

Low inflation expectations



Source: Federal Reserve, Bloomberg data, Macrobond Financial

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Balance sheet runoff ends in September

As expected, the Fed also announced that it may continue to hold its balance sheet constant for some time after the runoff ends in September and in addition it plans to swap its holdings of mortgage-backed securities for US Treasuries. Both measures are set to have a negative impact on the supply of reserves and US Treasuries available e.g. to banks to use in liquidity portfolios and thus constitute some sort of passive ‘quantitative tightening’, i.e. continued tightening of monetary conditions.

There was some speculation in the market leading up to the meeting that the Fed would introduce a new repo facility to complement its interest rate on excess reserves. There was no mentioning of this in its updated plans for balance sheet normalisation, though. However, in our view it seems likely that the Fed could introduce such a facility when the balance sheet runoff ends in September to help manage reserve supply going forward.

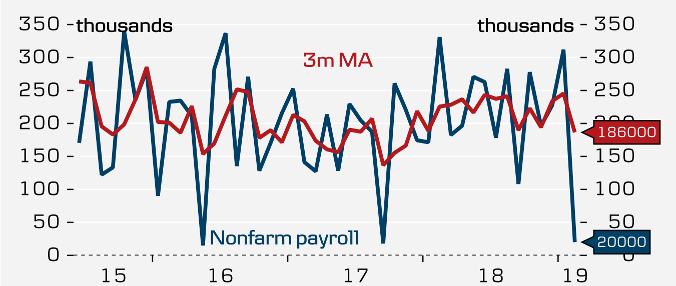
FX: limited downside potential for the USD from the current level

The Fed was more dovish on both rate guidance and plans for balance sheet normalisation, which sent the USD lower on a broad basis. A key driver of the drop in the USD was a spike in market-based inflation expectations, e.g. 10Y breakeven inflation rose 3bp. Consequently, EUR/USD spiked close to 1.145 and USD/JPY dropped to 110.7 on the announcement. The dovish Fed was also good for overall risk sentiment and caused among other things the oil price to spike higher, which lent some support to Scandi currencies.

From a relative growth perspective it seems somewhat counterintuitive that the USD is weakening, since the US economy in our view still looks relatively better off than the Eurozone, Japan or China. However, the Fed has more room to ease than e.g. the ECB and BoJ, which might explain the price action in the FX markets. **Given that the US rates market is now pricing a cut in US next year, we further see limited downside potential for the USD from the current level. Soon the market should shift its focus back to the ECB and whether it will deliver additional easing at the upcoming meetings. Hence, we remain confident in our 1.13 forecast for EUR/USD on 3M.**

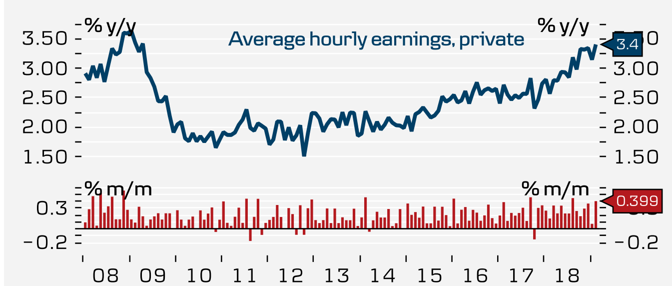
Charts

Employment growth still strong despite weak print in February



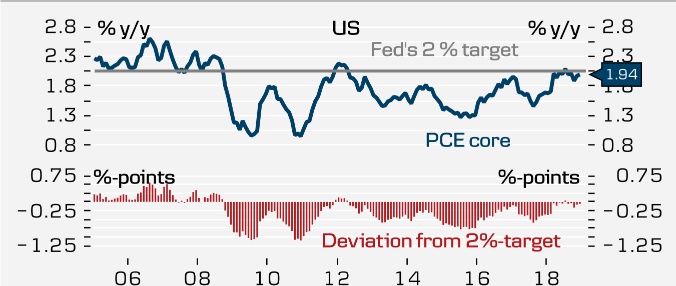
Source: BLS, Macrobond Financial

Wage growth is cycle-high



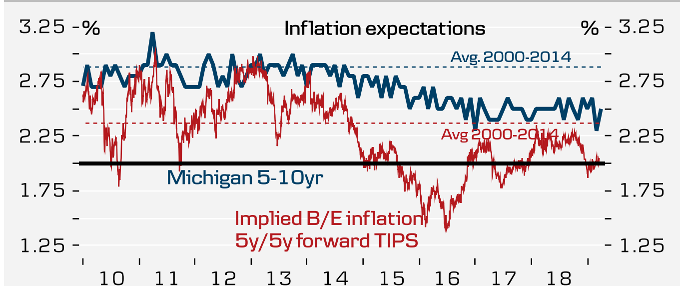
Source: BLS, Macrobond Financial

PCE core inflation has softened recently



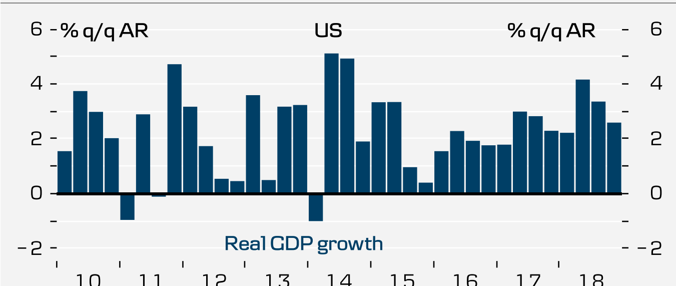
Source: BEA, Macrobond Financial

Inflation expectation still below historical average



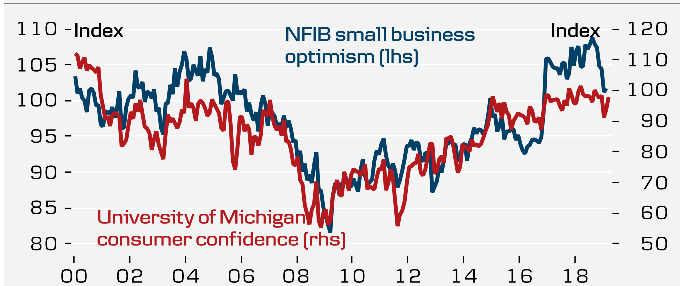
Source: Michigan, Bloomberg, Macrobond Financial

Strong GDP growth in 2018



Source: BEA, Macrobond Financial

Still high optimism



Source: NFIB, University of Michigan, Macrobond Financial

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Mikael Olai Milhøj, Senior Analyst.

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