3 March 2020

Fed Monitor

We expect easing of a further 50bp during the spring

Against our expectation, the Fed has moved ahead of the curve by cutting the Fed funds target range by 50bp before the ordinary March meeting. The Fed funds target range is now 1.00-1.25%. **As we think the situation will deteriorate before it turns better, it is difficult for us to see why the Fed should not cut further.** By cutting the Fed funds target range, the Federal Reserve has ensured that monetary policy is now neutral instead of tight. Given that the economic situation is likely to become worse before it gets better, we think the Fed needs to cut interest rates down to expansionary territory. Fed Chair Powell says the economy is strong but that the virus will weigh on economic activity for some time. **Powell repeated that the Fed is still ready to *'act as appropriate'*, i.e. still with an easing bias.**

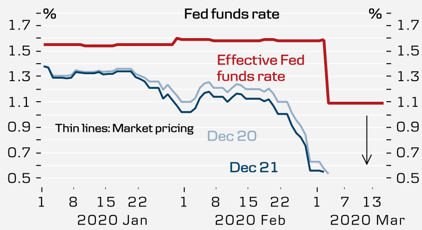
We expect the Federal Reserve to cut the target range by a further 50bp during the spring. With the Fed now cutting between meetings, it is more difficult to forecast both the size and timing of the rate cuts but we expect the Fed to cut by 25bp at the meeting concluding on 18 March. Another 25bp rate cut will soon follow, in our view, either before or at the April meeting, depending on the spreading of the virus and how it impacts the economy. It is hard to see why the virus should not spread further within the US, so we are skewed towards thinking the cut will arrive before the meeting in late April. We would not be surprised if the Fed also continues its injection of liquidity to markets.

For FX markets, the fact that the Fed is now showing a willingness to act gives a clear boost to EM carry strategies (lower US yields, weaker USD) and energy-intensive currencies such as NOK and RUB. Meanwhile, it also puts into question the case for continuing to pick up USD carry, and further unwinding of such positions, funded in e.g. EUR or SEK, could continue to support the latter versus USD. But, the likelihood that this pre-emptive Fed action limits the risk of a US recession further out also increases the possibility that FX markets return to an investment environment, where US asset outperformance and capital inflows could again support the greenback. Thus, while EUR/USD initially went quite a bit higher, there are also considerations which make EUR/USD a less likely candidate for upside risk. We see the current spot level in EUR/USD as being quite elevated and expect it to trade towards 1.11 short-term if risk sentiment improves only mildly. Should this policy action not be enough, declining equity prices continue to be a EUR/USD positive factor. Continued USD carry erosion does, however, change the monetary outlook for many countries where easing has been held back in fear of FX depreciation.

The emergency rate cut from the Federal Reserve shows that the global central banks are ready to act in order to contain the effects of the virus outbreak. Hence, we are seeing the US Treasury curve steepen and risk assets perform, such as European peripheral government bonds. **Given that the Federal Reserve is ready to do more, US rates are likely to remain low and the US Treasury curve can steepen further.**

The move from the Federal Reserve is supportive of European risk assets as it supports the possibility of a move from the ECB. Hence, spreads between the periphery and core EU are expected to tighten. It also take some pressure off the high coupon callables in the Danish mortgage market and supports spread tightening between the Danish callables and swaps/govts.

Investors expect the Fed to cut the target range by around 50bp further over the coming year



Note: Past performance is not a reliable indicator of future performance

Source: Federal Reserve, Bloomberg, Macrobond Financial

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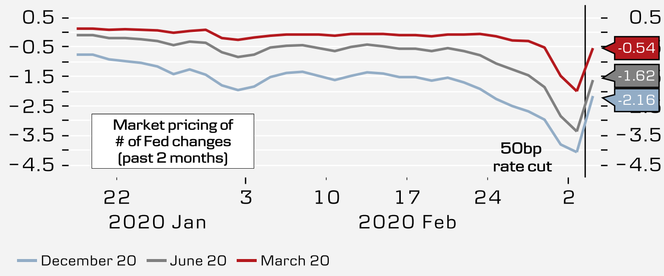
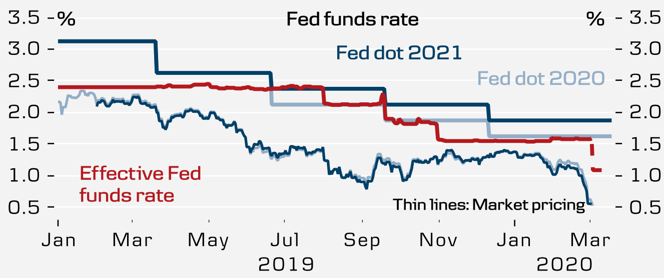
Investors are still pricing in more cuts



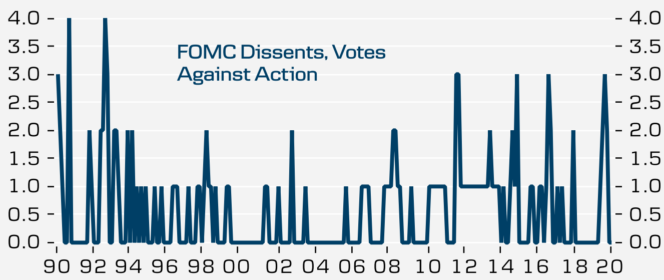
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, Macrobond Financial, Danske Bank calculations

Investors expect the effective Fed funds rate to bottom out around 0.5%



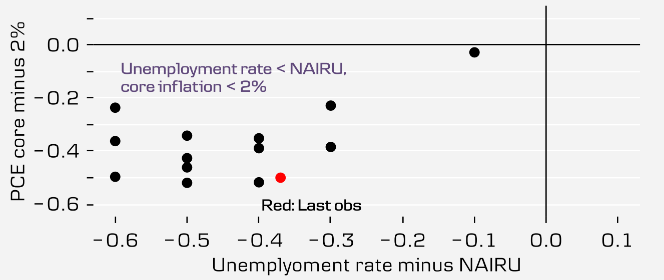
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, Macrobond Financial, Danske Bank

Fed prefers to work by consensus



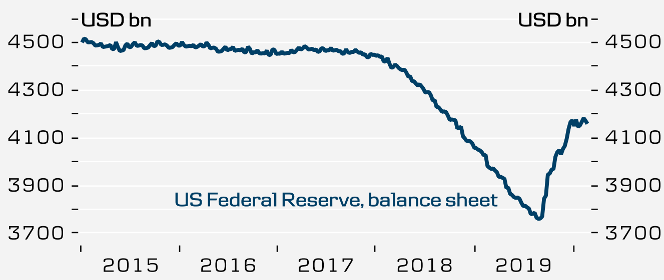
Source: St Louis Fed, Macrobond Financial, Danske Bank

Fed thinks it has fulfilled its maximum employment objective but inflation remains below 2%



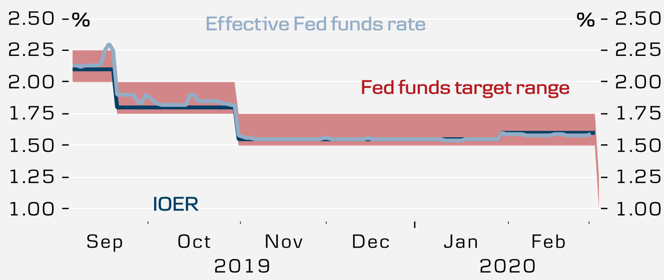
Source: Federal Reserve, BEA, BLS, Macrobond Financial, Danske Bank

Balance sheet is increasing



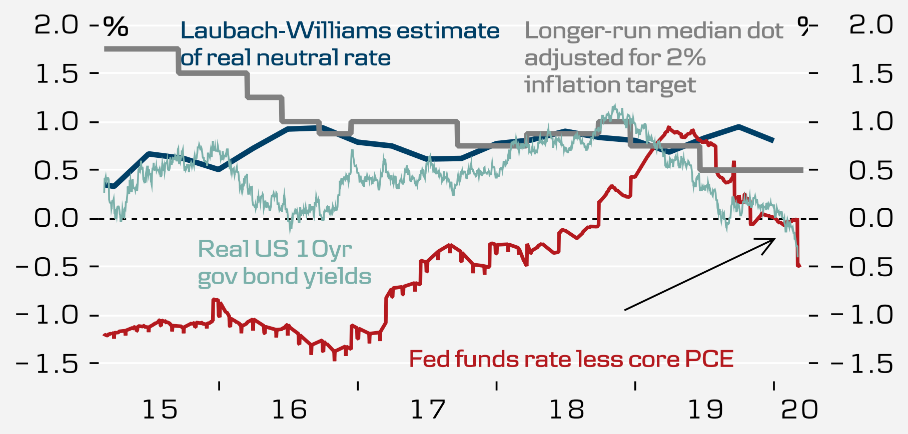
Source: Federal Reserve, Macrobond Financial, Danske Bank

Effective Fed funds rate remains below the IOER



Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Macrobond Financial, Danske Bank

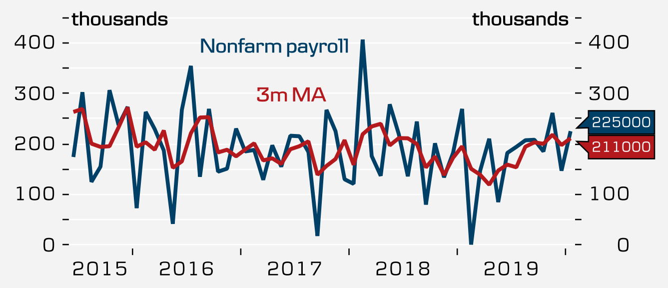
US monetary policy is too tight



Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

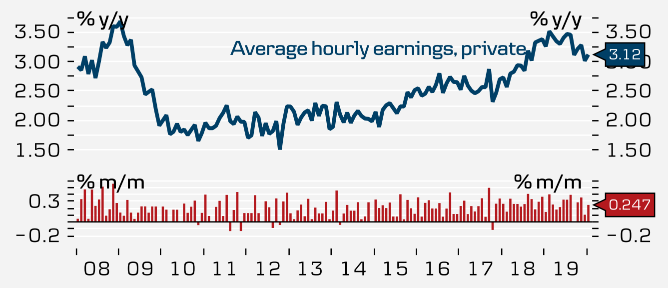
Macro charts

Employment growth is solid



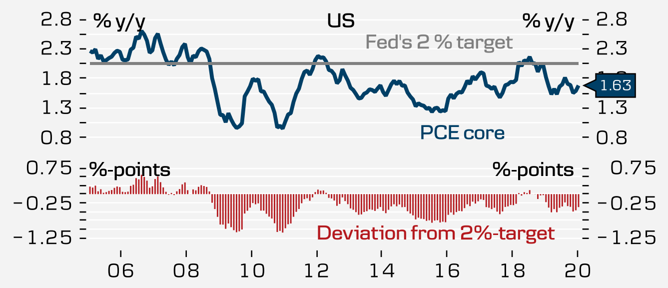
Source: BLS, Macrobond Financial, Danske Bank

Wage growth is not as high as previously but still decent



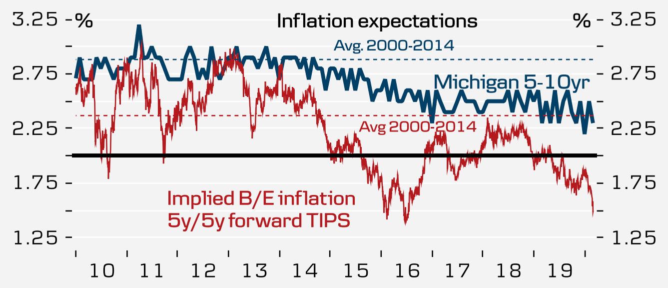
Source: BLS, Macrobond Financial, Danske Bank

PCE core inflation continues to run below the 2% target



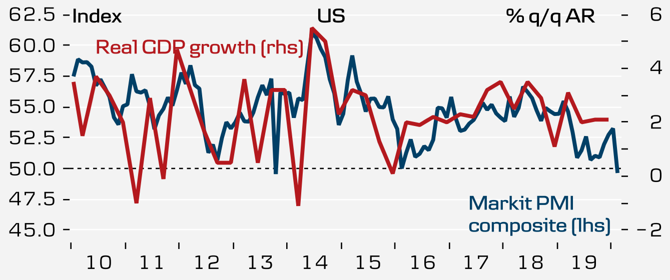
Source: BEA, Macrobond Financial, Danske Bank

Inflation expectations remain below historical average



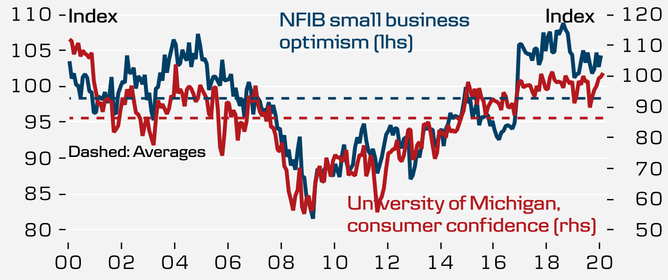
Source: Michigan, Bloomberg, Macrobond Financial, Danske Bank

Markit PMI service was extremely weak in February signalling 0% growth in Q1



Source: BEA, IHS Markit, Macrobond Financial, Danske Bank

Optimism remains high among consumers and small businesses amid coronavirus fears



Source: NFIB, University of Michigan, Macrobond Financial, Danske Bank

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