Investment Research — General Market Conditions

21 April 2021

Fed Monitor

Preview: Too early for the outcome-based Fed to change rhetoric

Key takeaways

- We expect the Fed to keep monetary policy and policy signals unchanged. It is one of the interim meetings without updated forecasts and dots.
- The Fed is outcome-based and not forecast-based and will not change rhetoric until they see the strong economic data.
- Based on our very positive US macro outlook, we continue to see the Fed moving in a more hawkish direction later this year. It may happen already in June or July but more likely in September.
- We continue to expect actual tapering will start in January 2022 (pace: USD20bn per meeting). We expect the first rate hike in H1 2023. Risk is tilted towards a more hawkish Fed (faster tapering pace and the first rate hike in 2022).
- The April FOMC is not expected to have any significant impact on the US bond market. We have a 2.0% six months target for 10Y UST yields.
- We do not expect the Fed meeting will have a significant impact on EUR/USD. With EUR/USD at 1.20 and our strategic view on real dollar yields, we see the surprise potential as being pro-US, towards a hawkish Fed and stronger USD in 2021.

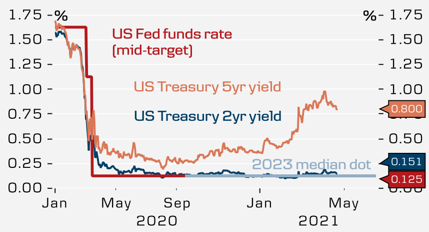
Fed: Outcome-based, not forecast-based

We do not expect the Federal Reserve to make any major changes at the upcoming meeting next week. It is too early for the Fed to shift gear because the pandemic is not over yet despite mass vaccinations, gradual easing of restrictions and better economic data. **Fed has made it clear that it is now outcome-based and not forecast-based so we need more normality and strong data for the Fed to turn more hawkish**. This also means that it is only natural that there can be a higher degree of divergence between market pricing and current Fed signals.

Everyone expects the Fed to keep policy rates and the bond buying pace unchanged. Fed Chair Powell, Fed Vice Chair Clarida and NY Fed President Williams were all dovish last week suggesting that the policy signals will remain unchanged. This means that the Fed will continue to say that *"it will be appropriate to maintain this target range (0.00-0.25%) until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time"* and that the bond buying pace is unchanged *"until substantial further progress has been made"*.

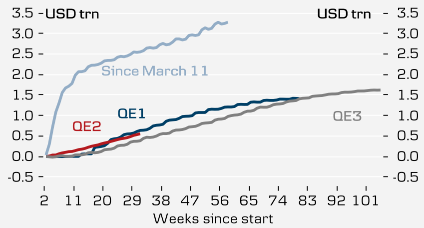
On growth, we expect the Fed to continue stating that *"indicators of economic activity and employment have turned up recently, although the sectors most adversely affected by the pandemic remain weak"*. On inflation, we expect the Fed to say that inflation is now above 2% but it mostly reflects base effects due to price falls in spring 2020. **It is one of the interim meetings so the Fed does not publish any new forecasts or dots at this meeting**.

Market pricing: Investors still think the Fed will tighten monetary policy earlier than what the Fed signals



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

The Fed still buys bonds for USD120bn per month but we expect tapering to start in Q1 22



Sources: Federal Reserve, Macrobond Financial

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In *Fed Monitor: Review – cautious now, hawkish later*, 17 March, we discussed the outlook for Fed policy going forward. **Based on our very positive US macro outlook, we continue to see the Fed moving in a more hawkish direction later this year. It may happen already in June or July but more likely in September**. The September meeting would give the Fed more observations to analyse of the post-COVID-19 US economy, which is quite important given its weight on outcomes and not forecasts.

We continue to expect the Fed will start tapering at the January 2022 meeting (pace: USD20bn per meeting). We expect the first Fed rate hike to arrive in H1 2023. Looking at the balance of risk, we think risk is tilted towards a more hawkish Fed tapering at a faster pace and hiking rates already in 2022.

US rates: Moving higher later in the year

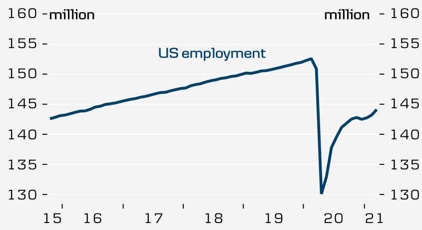
The April FOMC is not expected to have any significant impact on the US bond market. If anything the repeat of the "soft" stance from March might push US yields slightly lower.

However, the April FOMC is a 'small" meeting and all market attention will soon turn to the June and September meetings and the probability of a change of rhetoric and possible tapering news. We hold the view that the market will over the coming two quarters price in both an earlier and faster normalisation of US Fed funds and higher inflation and real rate expectations. **We have a 2.0% six months target for 10Y UST yields**. We assume that the market will start price in a rate hike in Q4 2022. For more see *Yield Outlook* that we published 21 April.

USD: Still expect a dollar comeback this year supported by more hawkish Fed

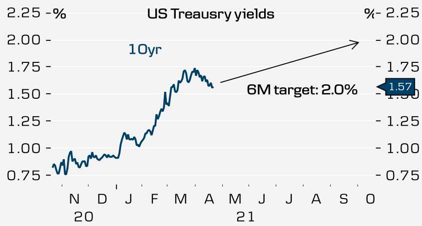
US nominal GDP will overshoot its pre-crisis trend the coming years - a striking difference compared to the aftermath of the financial crisis. Consensus forecasts of the nominal recovery in US and Europe suggest the US will be back on trend in Q4 and we suspect Fed will talk about this during Q2/Q3. In contrast, Europe will continue its recovery but the COVID shock appear permanent. As a base case, we expect the diverging nominal recovery will amplify pre-existing trends as the differential in earnings and rates widen in US favour. **On net, we thus see a strategically high risk that US real rates will make a comeback from their recent consolidation, supported by a recovery in nominal variables. With EUR/USD at 1.20 and our strategic view on real dollar yields, we see the surprise potential as being pro-US, towards a hawkish Fed and stronger USD**. Irrespective of this strategic view, the upcoming Fed meeting may be a lot more muted in terms of a dollar reaction, as we think Powell is most likely to simply buy more time at the current point in the corona crisis.

US employment is rising again, supported by gradual re-opening and mass vaccination



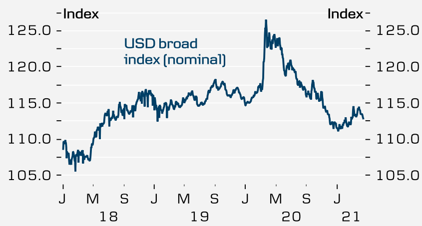
Sources: BLS, Macrobond financial

US rates: We have a 2.0% 6M target for 10Y UST



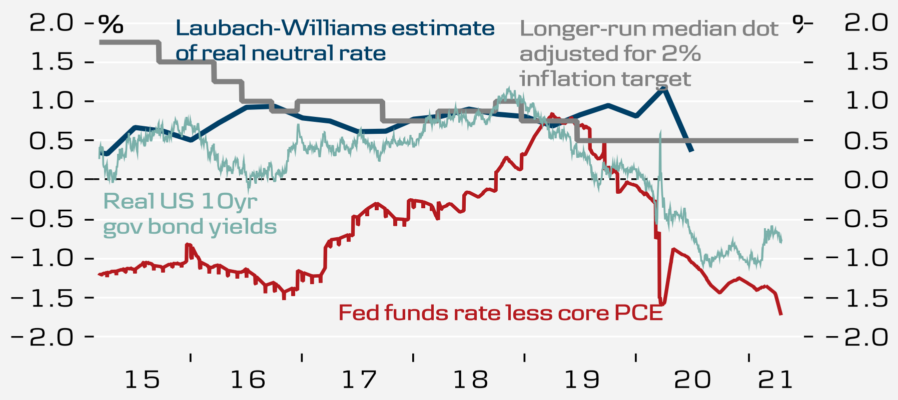
Note: Past performance is not a reliable indicator of current or future results.
Sources: Bloomberg, Macrobond Financial

We expect a broad-based USD comeback later this year, supported by a more hawkish Fed



Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.
Sources: Bloomberg, Macrobond Financial

Monetary policy is still accommodative despite higher real rates

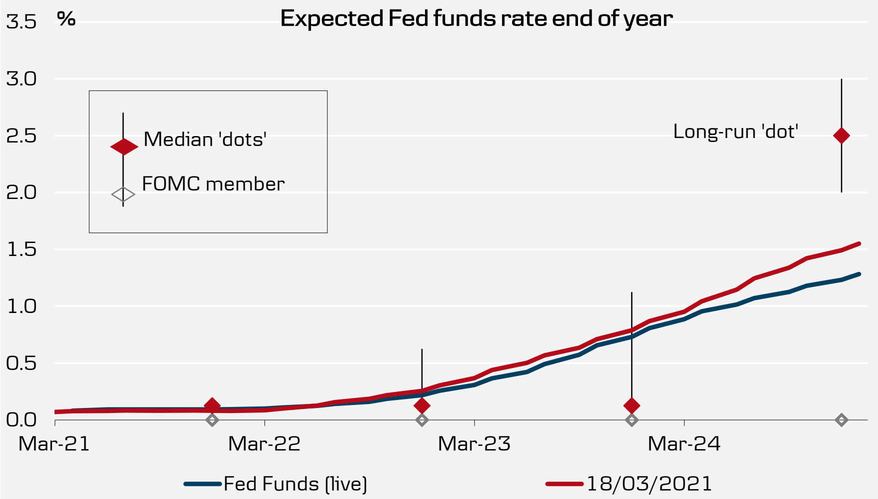


Note: Past performance is not a reliable indicator of current or future results.

Note 2: Laubach-Williams estimates are discontinued temporarily due to the pandemic distorting GDP
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

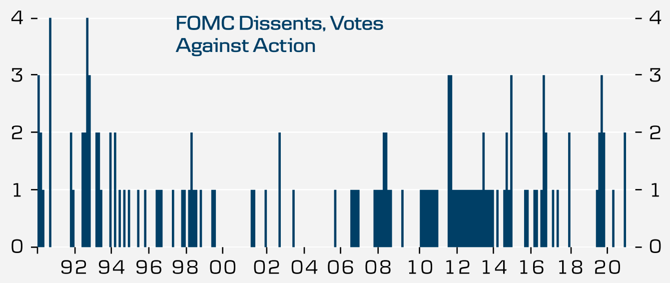
Fed charts

Fed signals vs market pricing



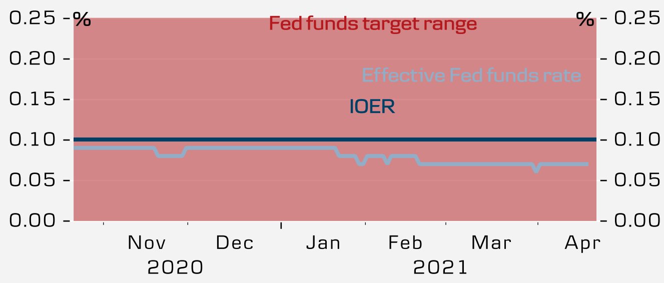
Sources: Federal Reserve, Danske Bank

The FOMC members usually work by consensus



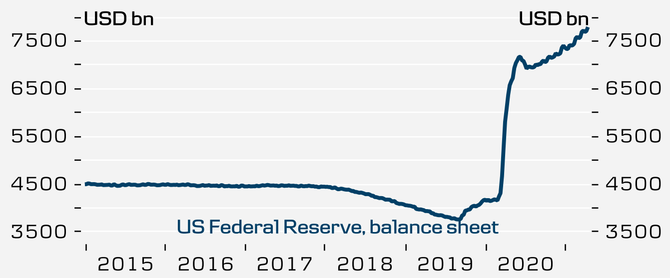
Source: St Louis Fed, Macrobond Financial, Danske Bank

The Fed seems reluctant to hike the IOER despite the effective Fed funds rate is in the lower end of the target range



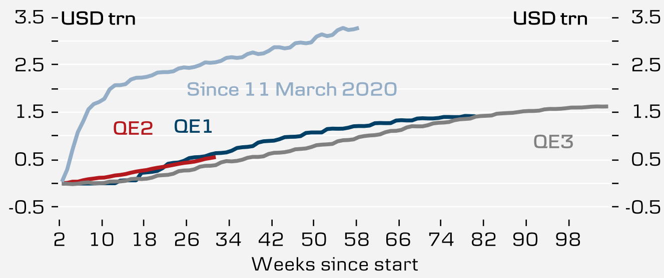
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Macrobond Financial, Danske Bank

US balance sheet continues rising



Source: Federal Reserve, Macrobond Financial, Danske Bank

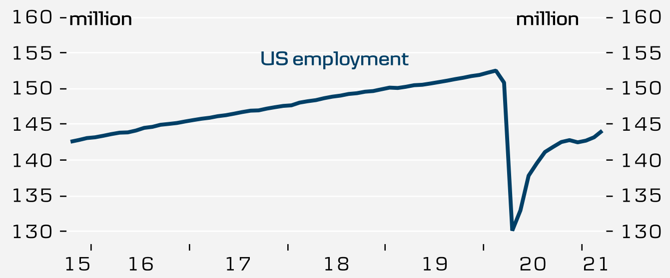
Fed buying USD120bn worth of bonds per month



Sources: Federal Reserve, Macrobond Financial

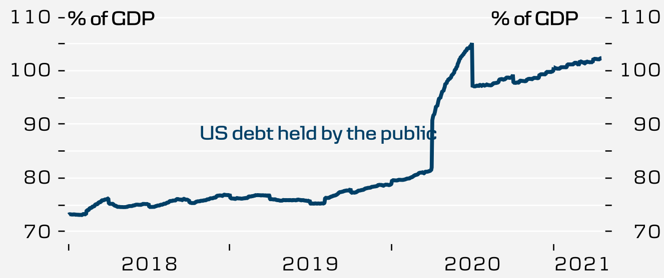
Macro charts

Employment is rising again supported by the re-opening



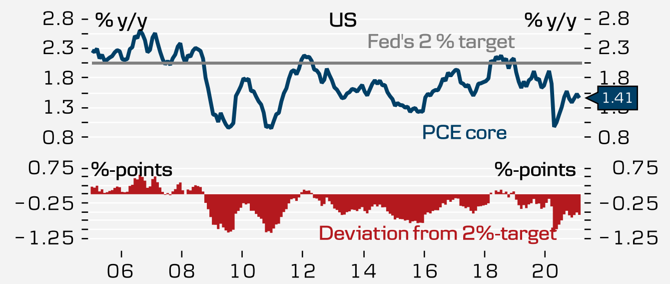
Source: BLS, Macrobond Financial, Danske Bank

US debt to increase further due to Biden's relief package



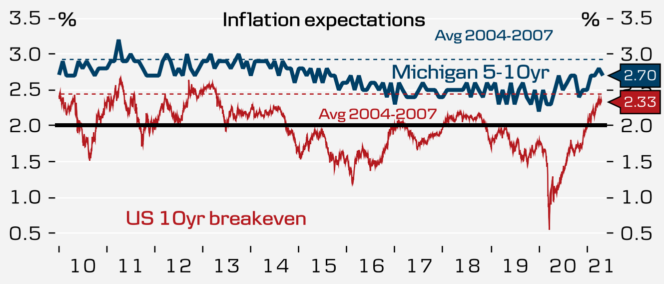
Sources: US Treasury, Federal Reserve, Macrobond Financial

Actual PCE core inflation is set to rise due to base effects after slower inflation spring 2020



Source: BEA, Macrobond Financial, Danske Bank

Inflation expectations have recovered, especially market-based measures



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

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