US: Fed Keeping Options Open

- **Fed signalled it would lift rates by 2023; officials discussed tapering but not in a formal sense**
- **Full recovery in employment, among key considerations, still has some ways to go**
- **USD to gradually strengthen, supported by yield differentials**

Background

The FOMC's latest decisions were in line with our earlier expectations for the fed fund rates to remain steady throughout 2021 and 2022, followed by a tapering in 2H22, and a first hike in 2023. This also ties with our view of only limited weakness in the USD for the rest of 2021, and its gradual shift to strength next year. Following the Fed more-hawkish-than-expected shift, the dollar may turn to a strengthening trend earlier than our current view of a bottom sometime in 3Q21.

Fed's shift not a huge surprise

The Fed's latest statement and its accompanying projections offered only a modest surprise to us, as a major surprise would constitute something along the line of bringing the first hike forward to end-2022. The fact that asset tapering was discussed was not surprising as well, after all it was quite impossible for Fed officials to not at least bring up the issue of scaling back its QE program, after the Fed first expressed such intention last month, and considering that it had been the focus of the markets for the past few weeks. Fed Chair Jerome Powell dubbed it a "talking about talking about" (tapering) meeting, affirming that the discussion was not in a sense "formal".

What ensued was the rise in short-to-medium term yields, as well as the shift in markets' expectations for the first post-pandemic rate increase. Fed fund futures now indicate a 90.3% chance of a hike in February 2023, compared to 73.6% pre-FOMC. There were also slightly higher expectations for it to happen as early as December 2022 (76.8% vs 68.2% prior) for those having an extremely bullish US outlook.

Discussion yes; but the Fed will likely maintain its policy guidance this year

We foresee the Fed to largely stick to this latest guidance for the remainder of the year, with more apparent change on QE tapering guidance likely in mid- to the later part of 2022. Firstly, it continues to shrug off the rising prices as being transitory which do not warrant serious inflation risks. Secondly, it appears that, despite the robust economic recovery and higher inflation expectations that have prompted such a change in forward guidance, the Fed still carries an underlying concern for the economy, particularly in the labour market which has yet to recover to its pre-pandemic level. The Fed has maintained its unemployment rate forecast at 4.5% for 2021 and slightly revised down the 2022 rate to 3.8%, from 3.9%. In comparisons, it has substantially upgraded the 2021 GDP growth and inflation projections. The next key event to watch for is Jackson Hole symposium in August.

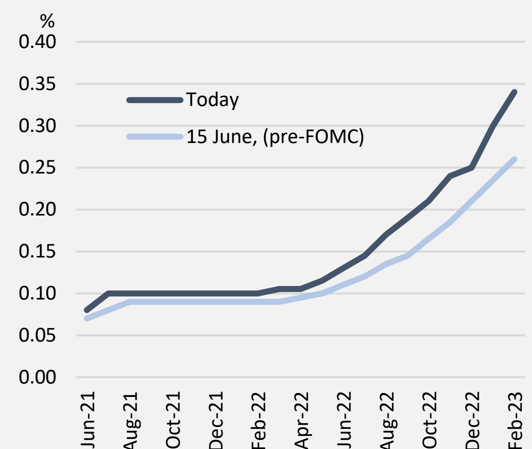
We have highlighted previously, what matters is really the pace of the job recovery moving towards end-2021 and 1H22, as inflation, transitory or otherwise, is priced in. Despite the rapid rate of job creations compared to the

Figure 1: Fed's latest projections indicate two rate hikes by end 2023

Median Projections			
	2021	**2022**	**2023**
Change in real GDP, %	7.0 (6.5)	3.3 (3.3)	2.4 (2.2)
Unemployment rate, %	4.5 (4.5)	3.8 (3.9)	3.5 (3.5)
Core PCE inflation, %	3.0 (2.2)	2.1 (2.0)	2.1 (2.1)
Federal funds rate, %	0.1 (0.1)	0.1 (0.1)	0.6 (0.1)

Source: The Federal Open Market Committee's Summary of Economic Projections, 16 June 2021 (figures in brackets were projections in March 2021)

Figure 2: Implied fed fund rates shifted up



Source: Bloomberg

post-GFC period, participation rate remained starkly lower (at 61.6% in May-21) than its pre-pandemic Feb-20's level of 63.3%. Besides, we have yet to see a normalised trend in wage growth that could sustainably support household spending.

Lastly, the shift in 2022's dot plot was also not as meaningful when compared to that of 2023. All 18 participants expect rates to be kept at near zero through 2021. For 2022, seven officials predicted higher rates, versus three in March. For 2023, the number rose to thirteen participants, compared to just seven in March. Fed Chair Jerome Powell also downplayed the dot plot, said it needs to be taken with "a big, big grain of salt". In terms of language, the Fed has turned more optimistic over the reduced effects the pandemic may have on the US economy, thanks to quick vaccination progress, but said that risks to the outlook remained.

Implications on the USD

The USD strengthened in response to the Fed's hawkish tilt. This was in line with our view of an imminently bottoming out USD, albeit coming in earlier than expected. We have forecasted the DXY to be 4% stronger between 3Q21 to 2Q22, driven by rising Fed taper expectations.

Hence, we only expect limited USD weakness over a 12-month period, from currently high yield differentials (between the US and other major economies) and positive market sentiments. The Fed will also provide ample lead up towards an actual move towards a tapering.

Central bank divergence may be a larger factor over the year ahead, with markets likely to positively position towards central banks that will be the first to tighten. Markets are currently expecting the Bank of Canada, Bank of England and the Monetary Authority of Singapore, to be relatively more hawkish than the European Central Bank and the Bank of Japan. This will likely imply at a more resilient CAD, GBP, and SGD, compared to the EUR and JPY over this period. Meanwhile, some Asian currencies may be more vulnerable to tighter US policy, given that Covid-19 continues to ravage many parts of Asia. Vaccination rates are lower than that of major economies.

Figure 3: Maintaining our forecasts

	Current	**3Q21**	**4Q21**	**1Q22**	**2Q22**
DXY	91.37	88.00	89.50	90.50	91.50
Fed Funds Rate, %	0 - 0.25	0 - 0.25	0 - 0.25	0 - 0.25	0 - 0.25

Source: HLBB Global Markets Research

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