Fed provides fuel for further USD gains

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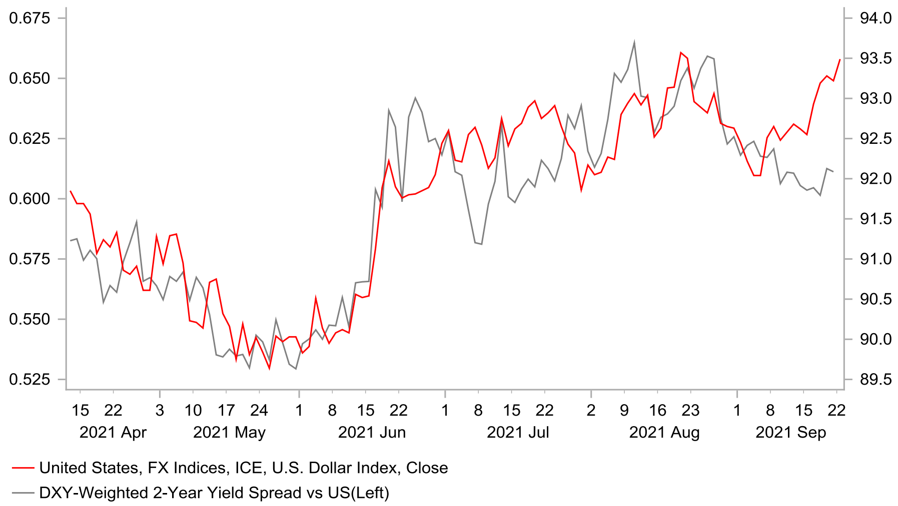
USD: The Fed delivers another hawkish surprise

The US dollar has continued to trade at stronger levels during the Asian trading session following yesterday's hawkish policy update from the Fed. It has helped to lift the dollar index back to within touching distance of the year to date high at 93.729 from 20th August. The US dollar and US short rates have been lifted by building expectations that the Fed will begin to raise rates as soon as next year. Those expectations have been supported by the signal from the Fed overnight that a "moderation in the pace of asset purchases may soon be warranted". The reference to "soon" implies that a taper announcement is likely at the November FOMC meeting provided that there is no negative shock in the interim period. The Fed is assuming that the debt ceiling stand-off will be resolved in the coming months. In the accompanying press conference Fed Chair Powell provided further guidance on the likely timing of the QE tapering process which he expects to be completed by "around the middle of 2022". On that timeline it would leave room for the Fed to then consider delivering a rate hike towards the end of next year if required.

The faster than expected timeline for QE tapering was also accompanied by a more

USD PERFORMANCE MORE CLOSELY LINKED TO SHORT-TERM YIELDS



Source: Bloomberg, Macrobond & MUFG GMR hawkish DOT plot revealing that Fed participants are both bringing forward rate hike forecasts and expecting more hikes to be needed over the forecast horizon. The dots show that two more members now expect the first rate hike next year leaving the committee split 50/50, and it raised the median forecast to 0.25%, up from 0.125% in June. The median forecast for 2023 year is now 1.00%, up from 0.625% in June which adds a further one-and-a-half 25bp hikes. The updated DOTS also showed rate hike forecasts for 2024 for the first time. The median for 2024 has been set at 1.80% which would bring the Fed funds rate closer to the long run forecast of 2.50%. A similar pace of tightening in 2024 to that delivered in 2023.

While the DOTs have not been a particularly accurate signal of Fed rate hikes over the years, they do send a clear signal that participants are moving in a more hawkish direction. The direction of travel would suggest that if the US economy continues to recover and inflation proves more persistent than expected then the Fed will be more active in tightening policy than we had been assuming. At the current stage the Fed does not appear overly concerned by the recent loss of growth momentum. The GDP forecast for this year was revised lower by 1.1 point to 5.9% but this was partially offset by an upward revision of 0.5 point to next year's forecast to 3.8%. The Fed is still sticking to their transitory inflation view. The inflation forecast for this year was raised by 0.8 point to 4.2% but only marginally by 0.1 pint for next year to 2.2%. Overall the hawkish policy signals should encourage a stronger US dollar especially against low yielding currencies like the euro. The more modest positive US dollar reaction overnight likely reflects in part that it had already strengthened sharply since late last week in advance of yesterday's FOMC meeting.