22 September 2021

Fed Research

Review: Fed is about to start a tightening cycle

Key takeaways

- The Fed recognises it is in a difficult position with subdued employment and high inflation. The Fed was overall more hawkish than markets and we had anticipated.
- The Fed says labour demand is high and that the labour market is tight by many measures (despite subdued total employment). Fed thinks "inflation is elevated". Only dovish comment was that delta is slowing the recovery. Fed Chair Jerome Powell is not concerned about the impact on the US economy of Evergrande at the moment.
- The Fed says tapering "may soon be warranted" and that it expects tapering to be concluded in mid-2022. The 'dot plot' was raised signalling a total of 6.5 rate hikes by year-end 2024.
- We expect the Fed to announce tapering at the next meeting in November and that the tapering pace will be approximately USD20bn per month, implying that tapering is concluded by mid-2022. We still expect the first rate hike in H2 2022, either in September or December.
- Fixed Income: The 2s10s US curve flattened because of Powell's hawkish message. The reaction in the US Treasury market was overall modest, however.
- FX: Also modest movements in FX space although EUR/USD broke below 1.17. Both EUR/NOK and EUR/SEK are trading around the levels before the announcement.

Fed: More hawkish than anticipated

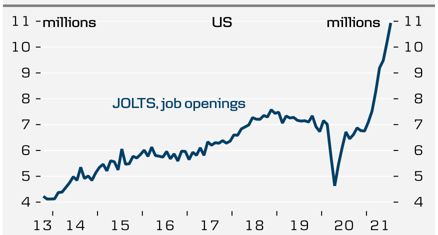
As we argued in our preview (Fed Research – Preview: What to do in a bad trade-off, 17 September), **the Fed finds itself in a very difficult situation**, as employment remains significantly below pre-covid levels (amid high labour demand), high inflation and increasing near-term inflation expectations. Fed Chair Jerome Powell recognised this during the press conference.

Overall, we expected the Fed to be slightly hawkish, but we think the Fed was more hawkish than anticipated. The most dovish part of the Fed meeting was that the Fed argues that the delta outbreak is slowing the recovery. Fed Chair Jerome Powell did not sound concerned about the impact on the US of the Evergrande situation.

To highlight where the Fed was hawkish

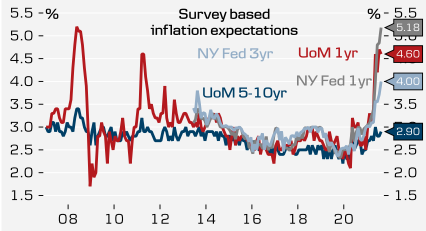
1) **Tapering:** The Fed included that tapering *"may soon be warranted"* and during the press conference Powell mentioned that a formal announcement may come as soon as at the next meeting in November. Powell was more concrete on the tapering pace than anticipated by saying it is likely appropriate to conclude tapering in the middle of next year. That corresponds to a monthly reduction of approximately USD20bn/month. Powell said the tapering plan has "very broad support".

Fed says labour demand is strong



Sources: JOLTS, Macrobond financial

Fed cannot ignore high inflation and higher short-term inflation expectations



Sources: NY Fed, University of Michigan, Macrobond Financial

Chief Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

Chief Analyst
Arne Lohmann Rasmussen
+45 21 46 29 51
arr@danskebank.dk

Senior Analyst
Lars Sparresø Merklin
+45 45 12 85 18
lsm@danskebank.dk

Chief Analyst, Head of FX Research
Kristoffer Kjær Lomholt
+45 45 12 85 29
klom@danskebank.dk

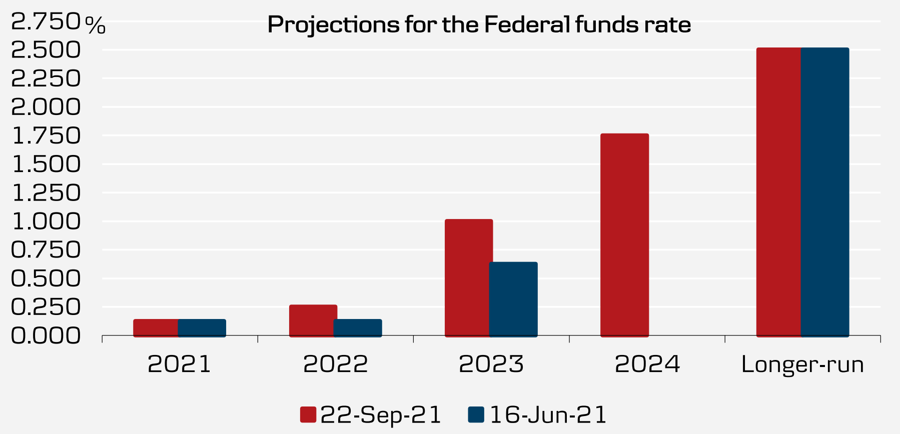
2) **'Dot plot':** The 'dot plot' was raised. The Fed is evenly split on a rate hike next year and have pencilled in three more hikes in both 2023 and 2024, taking the Fed funds rate (middle of the target) to 1.75% by year-end 2024, so a cumulative of 6.5 25bp hikes (see also chart below). The long-run dot was unchanged at 2.50%.

3) **Inflation:** The Fed says *"inflation is elevated"* although still arguing that it *is "largely reflecting transitory factors"*. During the press conference, Fed Chair Jerome Powell said that the Fed more than achieved what it wanted on inflation and also said that there are upside risks to inflation due to bottlenecks. Fed is signalling core inflation above 2% throughout the forecast horizon although Powell described the overshoot as being "modest".

4) **Labour market:** Powell said labour market conditions continue to improve and labour demand is strong. During the Q&A, Powell added that many policymakers think the *"substantial progress"* test on jobs has been met and that the labour market is tight by many measures. He also said that the September jobs report does not have to be extremely strong for the Fed to start tapering already at the next meeting in November, it just needs to be "reasonably good" (without saying what this means exactly).

Besides that Powell repeated that the Fed does not expect to hike before tapering is concluded and that the Fed has flexibility to increase/reduce the tapering pace if needed.

Higher Fed dots



Sources: Danske Bank, Federal Reserve

Fixed Income: Flatter 2s10s US curve

The 2s10s US curve initially bull-flattened a few bps despite the somewhat more hawkish taper language. It might reflect that despite the focus on 'elevated inflation' the Fed seems not overly concerned about the inflation outlook both reflected in the inflation forecast and the 'dots'. **However, as Powell said that tapering will be concluded mid next year, 2Y treasury yields moved 1.5bp higher and 10Y treasury yields moved back to the level before the meeting. But all in all market moves in US treasuries were modest on the announcement.**

For more on our view on US yields see *Yield Outlook: Tapering and slowdown pointing in opposite direction for yields* that we published September 21.

FX: We still expect stronger USD and weaker Scandis supported by the Fed

Although EUR/USD initially held its level upon release of the FOMC statement (1.1740), this was later pared in favour of a stronger dollar (1.1688 at the time of writing) as Powell went through the press conference. Indeed, falling short of actually announcing tapering, it was our reading of the press conference that Fed is on its way towards 1) tapering by November and 2) with a goal to hit zero purchases by mid 2022 and, 3) amid "very broad FOMC support". In addition, though some US data have been slightly weak, the FOMC seems willing to look through them, as it expects the recovery to continue. We share this assessment. As such, tapering is largely seen as a done deal.

We continue to expect EUR/USD to go even lower over the coming quarters, supported by Fed but also a peak in the global manufacturing cycle and fading some of the extraordinarily easy liquidity conditions. **We target 1.15 in 12M and 1.13 in 15M and see risks to the downside for these estimates**, as well as see a risk that our forecast may be realized sooner than currently expected in the main scenario. **In the very short-term, we may see some follow-through in the coming sessions, favouring a bit more dollar strength**.

The Fed meeting proved no game changer for our strategic bearish NOK view. The direction of US monetary policy is clear and there are no indications that the Fed is suddenly shifting in a dovish/patient direction. This removes an important tail risk for NOK bears. **Also global manufacturing will increasingly become a headwind for NOK this autumn and if we are right in our USD appreciation call above, it has historically rarely been a good environment to be long NOK FX in – even despite Norges Bank rate hikes**. We think temporary factors have supported NOK FX over the last weeks and still like the risk reward of selling NOK FX via options. **Tomorrow's Norges Bank meeting could well be a "buy the rumour – sell the fact"-event**. For more on our Norges Bank expectations please see *Reading the Markets Norway*, 16 September.

Our Fed call summarised

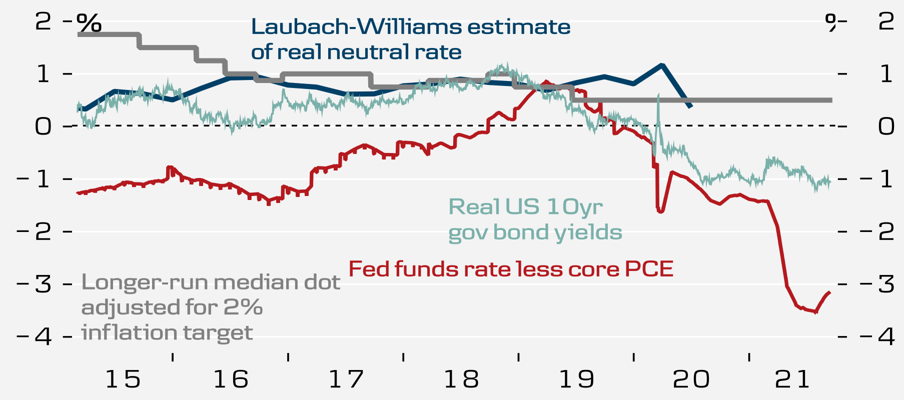
The Fed was more hawkish than anticipated at the September meeting supporting our call that the Fed is about to start a tightening cycle including both tapering and rate hikes.

We expect the Fed to announce tapering at the November meeting and for the Fed to reduce the QE bond buying pace by approximately USD20bn per month. This would conclude tapering by mid-2022, in line with what Fed Chair Powell said at the September meeting.

We continue to expect the first rate hike in H2 2022, either in September or December. We expect this to be the beginning of a hiking cycle, implying three-to-four rate hikes in 2023.

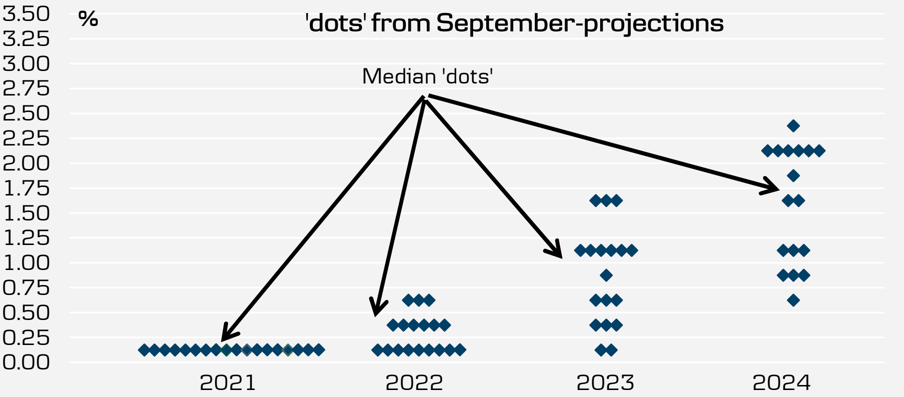
Fed charts

Monetary policy is still accommodative



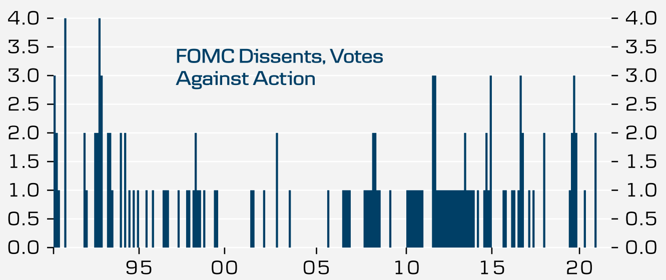
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

Fed dot plot from September



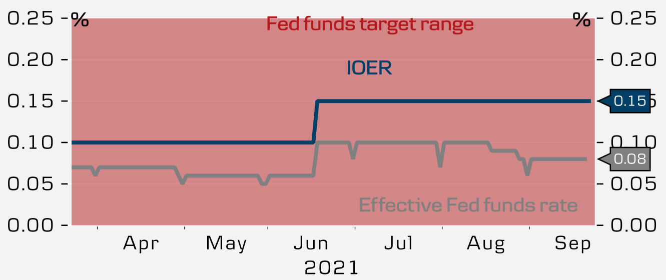
Sources: Federal Reserve, Danske Bank

The FOMC members usually work by consensus



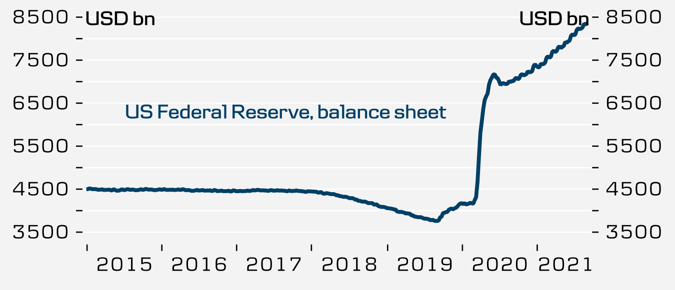
Source: St Louis Fed, Macrobond Financial, Danske Bank

Effective Fed funds rate rose after the IOER rate hike in June



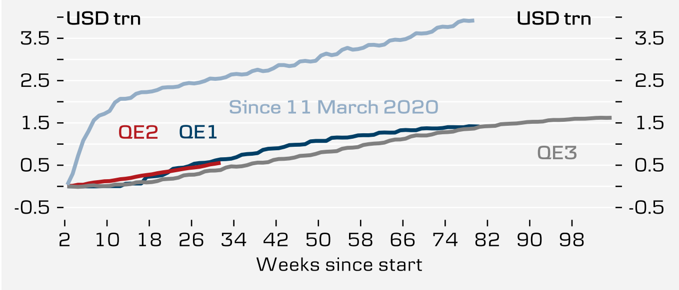
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Macrobond Financial, Danske Bank

US balance sheet has been increasing rapidly



Source: Federal Reserve, Macrobond Financial, Danske Bank

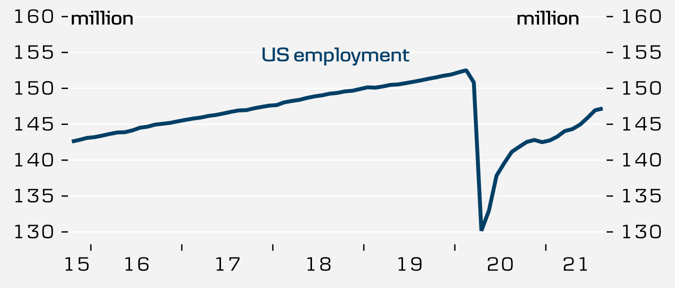
Fed is still buying USD120bn worth of bonds per month



Sources: Federal Reserve, Macrobond Financial

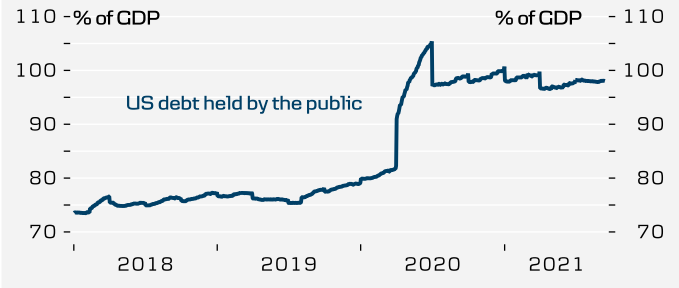
Macro charts

Employment remains significantly below pre-corona levels but jobs indicators are overall strong



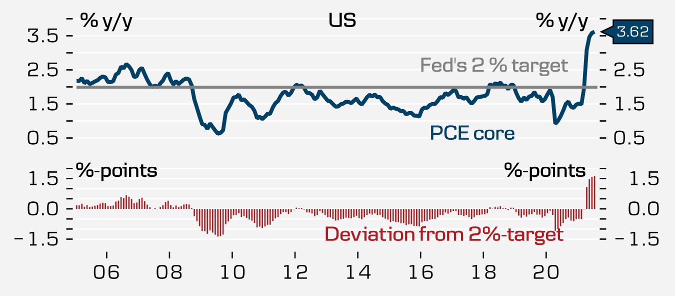
Source: BLS, Macrobond Financial, Danske Bank

US debt to increase further



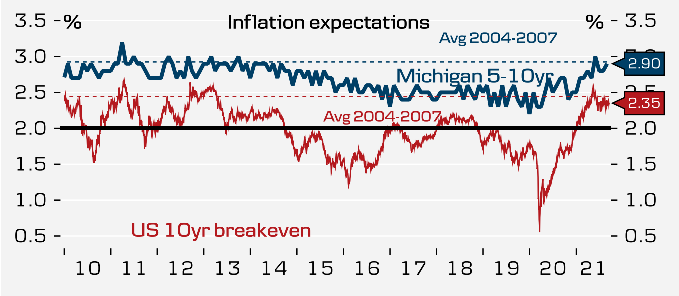
Sources: US Treasury, Federal Reserve, Macrobond Financial

PCE core inflation has moved sharply higher



Source: BEA, Macrobond Financial, Danske Bank

Inflation expectations have risen since 2020 but remain well-anchored



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