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FX Strategy Observations

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Dollar gains after Fed’s hawkish shift, G10 central banks prepare for exit from easing

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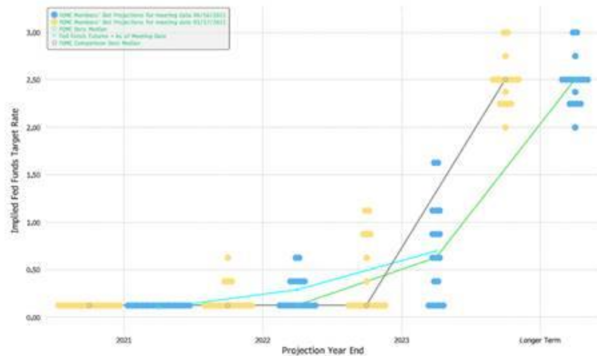
Summary:

- At their policy meeting on June 16th, the Federal Open Market Committee (FOMC) announced that it left the Fed Funds Target Rate (0-0.25%) unchanged, which was expected. The “dot plot”, or individual committee members’ current expectation for future rate hikes, was adjusted higher and now implies two rate hikes by the end of 2023 (median of 0.625%) with more members also now in favor of a rate hike in 2022 (Figure 1). The Fed adjusted 2021 projected Core PCE inflation up from 2.2% to 3.0%, while 2022 was adjusted up from 2.0% to 2.1%. In the statement itself, no mention was made of “tapering” the Fed’s $120bn in monthly securities purchases, though St. Louis Fed President James Bullard (non-voting) indicated today that Chairman Powell “officially opened taper discussions this week”.
- Treasury bond prices initially spiked lower on the Fed announcement, with the 5-yr Treasury rate moving from 0.78% to 0.88%, while the 10-yr Treasury rate moved higher from 1.49% to 1.57%,. However after this initial move, The Treasury curve flattened with the 10y trading back to 1.50%, as the market appears to be interpreting the Fed’s communications as implying a sooner-than-expected Fed Funds rate hike, which in turn would lead to a slowing rate of inflation.
- The TIPS implied 10-yr real yield also surged to -0.75%, the highest since April, supporting a move higher in the USD (Figures 2-3). As the 10-yr nominal yield moves this year towards our 2.0% projection for end of 2021 and inflation stabilizes, we expect real yields to turn positive in 1H22.
- Market complacency over US monetary policy was appropriately shaken. We see the rate outlook as tilted higher over time, but not even a minimal threat to economic recovery. While bond yields at the belly of the curve jumped by the most in almost four months, the jump is not comparable to the rise in inflation this year. This is because of Fed credibility which in turn requires the Fed to gradually slow the pace of easing, moving monetary policy to a more sustainable, post crisis path.
- Inflation has likely peaked as components of inflation prove to be transitory. A key message from Wednesday is that Fed policy – while permissive of somewhat higher inflation overall – will not accommodate uncontrolled inflation, and that has strengthened the USD and resulted in long-term bond curve flattening, for now (see our CIO Bulletin of June 13).

Figure 1: Shift in FOMC "dot plot" from March 15th to June 16th meetings



Source: Bloomberg and Factset as of June 16, 2021.

Figure 2: US nominal and real yields both jumped following FOMC statement

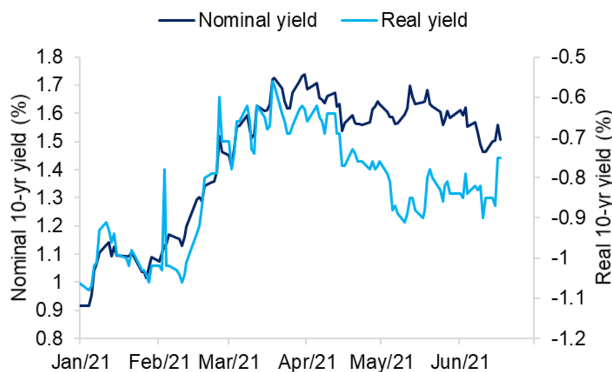


Figure 3: Higher real yields will support the USD

Source: Bloomberg and Factset as of June 17, 2021. Past performance is no guarantee of future results. Real results may vary.

As a majority of DM countries have either entered or are close to fully re-opening, we expect the COVID-driven growth differential to narrow further. The key driver for DM currencies in the medium-term will be central banks' respective policy normalization timelines. Among G10 central banks, the Fed is leading the ECB, the BoJ and the RBA in signaling the possibility of policy normalization, and lagging Canada (which started tapering in April), New Zealand (which hinted at its first rate hike in September 2022), Sweden (which announced in April that it would let QE expire at end of 2021) and Norway (which could hike twice in 2H21 and twice more in 1H22). Given the Euro and Yen's combined weight in the DXY index, we would expect a rebound in the dollar index in the short to medium-term.

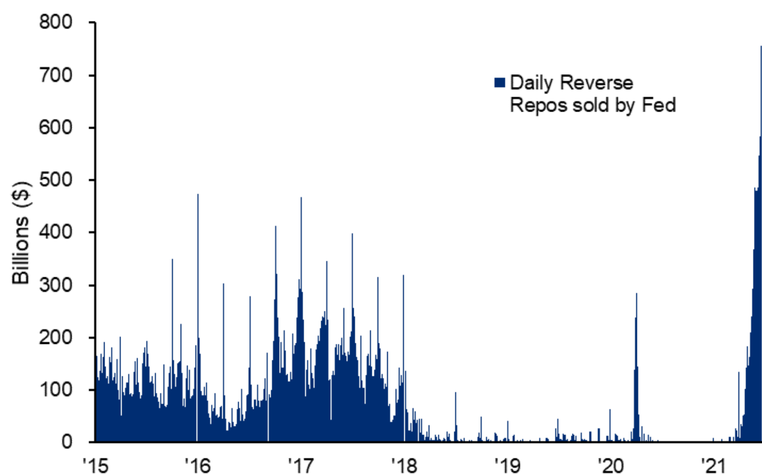
In particular, any uncertainty about the ECB's stance was cleared up after ECB President Lagarde cautioned that it was too early to debate the end of PEPP, and that she hoped to present the ECB strategy review results at the end of summer. ECB chief economist Lane also reminded the market about how dovish the ECB is compared to the FOMC, noting that it would be pre-mature to talk about tapering bond purchases in the Euro zone even in September. It is almost certain now the Fed will move ahead of ECB, which could push the USD up against the Euro.

The BoE, on the other hand, did scale back its weekly bond purchases but left the total QE size unchanged at £895 billion (£875 billion in UK government bonds and £20 billion in corporate bonds). The move "is not a tapering decision," as emphasized by BoE governor Andrew Bailey. The May CPI showed a 2.1% YoY change, topping the BoE's 2% target. Inflation could rise even higher as the UK plans on fully lifting its COVID restrictions. This should eventually subside and have limited impact on BoE's immediate actions. The June policy meeting will provide more guidance in terms of the BoE's view on the country's economic recovery. No substantial monetary policy changes are likely until there is visible strength

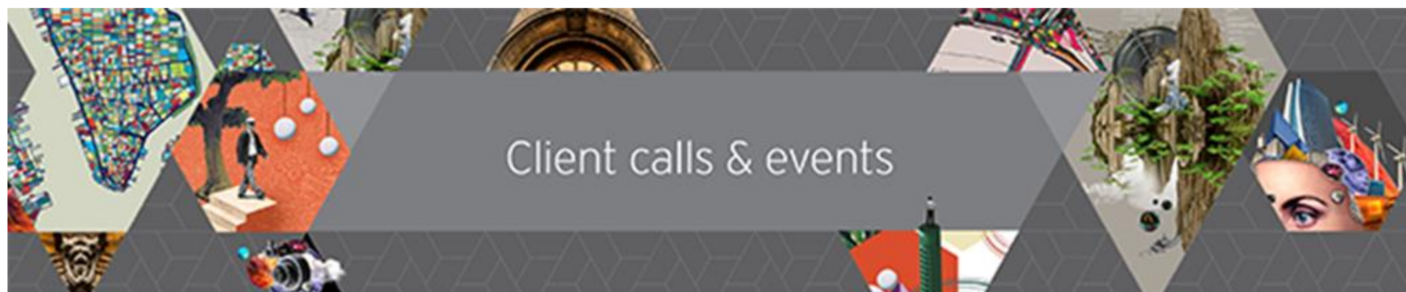
after the end of the fiscal emergency support measures. The November BoE meeting will likely be critical. If the growth rebound disappoints, a further £50 billion quantitative easing extension may occur. But if the rebound is strengthening into a firm 2022 recovery, the BoE may signal monetary tightening to come, which could drive the yield and the sterling higher.

In addition, we recently discussed the USD liquidity dilemma and its bearish influence on the USD (see [Global FI Strategy Bulletin of May 27] and [June FX observations]). The Fed's decision to raise the IOER and Overnight Repo Rate by 5bps could provide some relief to the large cash build-up at the overnight end of the yield curve for both banks and money-market funds. The overnight reverse repo volume soared to over $750 billion on June 17th (Figure 4). The USD excess liquidity will shrink once the Fed starts tapering, which could help the USD strengthen.

Figure 4: Federal Reserve overnight reverse repos



Source: Bloomberg and Factset as of June 17, 2021. Past performance is no guarantee of future results. Real results may vary.



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