

The Federal Reserve: A dovish guidance?

- *The Federal Reserve maintaining status quo was in line with expectations especially considering the disappointing payroll reading in May.*
- *However, the main focus was on the post policy statement and forecasts. In this regard, the changes that were made to forecasts—downward shift in policy rate projections and increases in inflation forecasts—does suggest that the Fed has made a slight change to its reaction function and implies a very gradual monetary tightening cycle over the medium to long-term.*
- *The Fed is likely to remain cautious and wait for ample evidence that wage inflation pressures are accelerating before it decides to pull the trigger yet again.*
- *However, the main focus in the near-term for investors is likely to be the 'Brexit' vote. Were the UK public to vote to leave the EU, it could result in an increase in volatility and risk aversion.*
- *Both the EUR and GBP are vulnerable to depreciation pressures in the near-term at least until the uncertainty about the UK's position with regards to its membership in the EU remains in place.*
- *The JPY is poised to appreciate in the near-term given the balance of payments dynamics at play of a current account surplus and capital inflows on the back of positive real rates and risk aversion in the global markets.*
- *There is also growing belief that the BoJ's monetary policy toolkit is empty and that it has limited ability to influence either the economy or the exchange rate. This was a key reason why markets sold off early in today's trading session in response to the BoJ maintaining status quo.*
- *The INR will likely be influenced by global risk aversion in the near-term. We see further depreciation over the course of 2016.*

FOMC: A change in the reaction function

After Fed officials spent most of May building up the case for tighter monetary policy, there were no substantial changes made to the tone of the post policy statement as compared to the previous meet in April. Besides, Fed Chair Yellen continued to emphasize data dependence of future actions. The change in tone was primarily a function of the unbelievably weak payrolls figures for May as the Fed needs some reassurance that the recent weak figure was just a blip. The uncertainty about the state of the US economy is perhaps best illustrated in the FOMC's opening statement in which it states that '*information received since the Federal Open Market Committee met in April indicates that the pace of improvement in the labor market has slowed while growth in economic activity appears to have picked up*'. The situation was exactly the reverse in the previous policy meet in which labour market conditions were improving but growth had slowed in 1Q2016.

The Federal Reserve made some small changes to its post policy statement to take into account recent developments. For instance, there was some acknowledgement that 'household spending had strengthened' and that 'the housing sector has continued to improve'. The Federal Reserve's assessment on inflation remains unchanged as it expects inflation to move towards its 2% target over the medium term.

However, a critical change made was on the forecasts that the Federal Reserve provided.

- While the median rate forecasts for end-2016 was unchanged at 0.9%, 6 of the 17 Fed officials now expect only one rate hike in 2016. Most importantly, the median rate forecasts were lowered for 2017 from 1.9% to 1.6% and there was a further downward revision made to the end-2018 forecasts from 3% to 2.4%.

- GDP growth projections were left more or less unchanged. There was a minor downward revision but on balance the Fed sees the economy growing around its potential rate for a considerable period of time.
- The Fed expects the unemployment rate to level out at around 4.6% mark but there could be further downward revisions made in the future.
- Core PCE inflation was expected to accelerate only very modestly from 1.4% in 2016 to 2% in 2018 despite the fact that the unemployment rate is expected to remain below the full-employment level of 4.8% for a consistently long-period of time.

US Federal Reserve Median Projections (June, 2016)				
	2016	2017	2018	Longer Run
Change in real GDP	2.0	2.0	2.0	2.0
March projection	2.2	2.1	2.0	2.0
Unemployment rate	4.7	4.6	4.6	4.8
March projection	4.7	4.6	4.5	4.8
PCE inflation	1.4	1.9	2.0	2.0
March projection	1.2	1.9	2.0	2.0
Core PCE inflation	1.7	1.9	2.0	
March projection	1.6	1.8	2.0	
Federal funds rate	0.9	1.6	2.4	3.0
March projection	0.9	1.9	3.0	3.3

The simultaneous action of raising the inflation projections on the assumption that labour market conditions are likely to remain tight along with reducing the policy rate projections implies that the Fed has lowered its sensitivity to inflation. One explanation for the divergence in forecast changes is that the Federal Reserve is incorporating other international developments (global disinflationary pressures) that could influence price pressures in the US economy. Whatever the reason, **it has become fairly apparent that the Fed has altered its reaction function implying that monetary policy will tighten only very gradually over a period of time.** However, the Fed needs to be first convinced that inflation pressures are poised to accelerate before it can tighten policy.

Can the Fed tighten policy?

A critical question is whether the labour market developments improves that drives wage inflation pressures higher over the medium term. We reiterate that we view the weak payroll reading in May as an aberration considering other survey evidence that shows labour conditions to remain fairly tight. **As the economy approaches its full-employment level, there is likely to be a problem with the supply of labour that will likely result in lower pace of cumulative monthly job increases. However, tighter supply should also translate into an acceleration in wage inflation pressures that should in turn mean upside risks to core inflation pressures.**

Until there is ample evidence to suggest that wages are accelerating, the Fed will likely maintain status quo. There are always a lead-lag relationship between labour market tightness and wage inflation pressures.

Hence, it is quite possible that wages will pick-up over a period of time not immediately. Hence, we see case for at least one 25 bps rate hike in 2H2016 or possibly 50 bps only if payrolls start to show renewed strength that translates into a pick-up in wage inflation pressures. Further monetary tightening is possible over 2017-18.

Market implications:

- The market had already priced in status quo from the Fed and a dovish guidance given mixed nature of US economic data flow. Hence, there was a limited response.
- **We reiterate our call that the next wave higher in the USD over the medium term will likely come from real rates turning positive** (FX update: The USD to remain in demand, June 1 2016). The uptrend in the USD over 2014-15 was driven more by weaker growth in the non-US world that forced central banks to turn accommodative. Hence, global yields converged towards US yields creating a strong flow effect that provided the USD with strong support. However, the next and last leg of USD uptrend is likely to come from the Fed tightening policy.
- **The main focus in the near-term is on the impending 'Brexit' vote** or rather the vote by the UK public on whether they want to remain part of the European Union that is due on June-23 2016. The BoE monetary policy meet due later on today could warn investors about the adverse implications of the UK leaving the EU could have on the economy. This could in turn mean further downside for risky assets.
- **Most polls seem to suggest a close race but that there is more support for the UK to remain part of the EU rather than leave the region.**
- However, **were the vote to come in favour of an exit, we see a 'soft-Brexit' scenario as our base-case.** In a 'soft-brexit' scenario, we assume that the UK economy either joins the European Economic Area (EEA) or re-negotiates bilateral trade agreements like Switzerland has. Under such a scenario the loss to trade could be short-lived and there could also be some concessions provided to the UK financial sector. This could mean limited output loss but a period of heightened risk aversion and financial market volatility.
- Both the EUR and GBP are likely to remain vulnerable until the vote given strong trade-links between the UK and the Euro-zone. The UK probably has more to lose given that it has a trade deficit with the Euro-zone.
- We see two scenarios for both currencies:
 - (a) **Base-case: Brexit is avoided:** In such a scenario, both the EUR and GBP rally in relief. The GBP/USD pair could touch a high of 1.46. However, appreciation in the GBP will likely remain short-lived as focus could shift back to weakening domestic growth prospects and tighter US monetary policy. The EUR/USD could rally in the near-term all the way 1.14-1.15 but weaken over 2016 in response to divergences in monetary policy stances between the Fed and the ECB.
 - (b) **Alternative scenario: UK votes to leave the EU:** The GBP is likely to collapse all the way down to 1.35 in the near-term. However, some degree of intervention from the BoE along with assurances from policymakers that terms are likely to be re-negotiated could calm anxiety after

a very volatile period. The EUR is likely to move only marginally lower towards the 1.08 level. While there could be concerns about a hit to growth prospects and questions about the viability of the EU project, there could be an increase in inflows into German bunds limiting downtrend in the currency. The USD, JPY and CHF could rally sharply in such a scenario.

- **Whatever the outcome of the 'Brexit' vote, the one thing that we are convinced about is that the JPY could appreciate in the near-term.** The balance of payments dynamics makes currency depreciation that much more difficult. For one, a current account surplus means that the JPY can only depreciate if capital outflows exceed the current account balance. However, that seems difficult at the current juncture. Real rates (nominal rate + inflation) on the back of negative policy rates and deflation are likely to restrict capital outflows. The heightened degree of risk aversion that could result in an unwinding of JPY carry trades could somewhat exaggerate appreciation pressures on the currency. There is also growing belief that the BoJ's monetary policy toolkit is empty and that it has limited ability to influence either the economy or the exchange rate. This was a key reason why markets sold off early in today's trading session in response to the BoJ maintaining status quo. We would not rule out downside towards the 102.00 level in the near-term especially in a build-up to next week's 'Brexit' vote.
- An uptrend in the USD/JPY is possible in 2H2016 if the Fed tightens policy that results in a widening in yield differentials between US and JPY sovereign yields.
- **We are maintaining our INR depreciation call over 2016.** An adverse global risk environment on the back 'Brexit' concerns in the near-term followed by the prospect of tighter US monetary policy and concerns about the Chinese economy is likely to restrain fund flows into the domestic markets. The improvement in the basic balance of payments position (current account minus FDI flows) could restrain the pace of depreciation. However, we maintain our call of a possible upside of 68.50-69.50 for the USD/INR pair by end-2016.

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