

The Federal Reserve: upgrades its assessment on the economy

Summary:

- *The Federal Reserve mildly upgraded its assessment on the economy responding to improved data flow over 2Q2016. It also emphasized that near-term risks to the economic outlook have diminished.*
- *However, the Fed explained that it will continue to 'monitor international and financial market developments'.*
- *We reiterate that the Federal Reserve has to strike the right balance between conflicting domestic and external set of factors. Hence, we maintain our call of one 25 bps rate hike likely in December-2016.*
- *We see a strong case for divergence in the USD's performance in the near-term. We expect the USD to appreciate against the non-commodity G-7 currencies like the EUR, GBP and JPY but see some weakness against the EM currency block.*
- *The USD could resume a more broad-based uptrend in 4Q2016 into 1H2017 when the Fed does indeed pull the trigger.*
- *The USD/JPY could move higher in the near-term if the BoJ does expand the quantum of monetary stimulus in its policy meeting due tomorrow.*
- *The INR is likely to remain responsive to global risk sentiment rallying in the near-term but coming back under pressure towards end-2016 to 1H2017.*
- *We expect the EUR and GBP to remain vulnerable to depreciation pressures.*

FOMC: A review of the policy statement

The FOMC made some subtle changes to its post policy statement to reflect the improvements that have taken place in the US economy over 2Q2016 and visible stability in the financial markets since the last policy meet in June. The key takeaways from the statement are as follows:

- **Mild upgrade:** The new statement did mark a turnaround from the one that was released in June. The policy statement released last evening showed that the Federal Reserve was more upbeat on the economy reflecting the fact that retail sales have been strong, payrolls have rebounded, industrial production has improved at the margin and most survey indicators have shown continued traction in domestic demand.

In the statement, the Fed emphasized that the labour market 'strengthened' and that consumption has been 'growing strongly' but emphasized that business investments remains 'soft'. The statement that job gains had 'diminished' that was present in the June meeting reflecting the weak payrolls figures in May was removed completely in the policy statement that was released yesterday. The statement also shows that Fed officials viewed the unexpected weakness in payrolls in May as a temporary blip.

- **Risks have diminished:** This FOMC statement also emphasized that the 'near-term' risks to the economic outlook have 'diminished' perhaps indicating that the Fed is ready to tighten policy if economic data flows shows continued strength.
- **US inflation expected to pick-up in the medium term:** The Federal Reserve maintained its view that inflation is being held back by temporary factors such as soft global commodity prices and an appreciated currency. The majority still expect inflation to move towards the Fed's 2% objective over the medium term. However, there was continued acknowledgement that inflation expectations remain fairly low.
- **International developments are still important:** The post policy statement also emphasized that the Fed will continue to 'closely monitor' global economic and financial developments. This in turn means that swings in market risk sentiment will continue to factor into the Federal Reserve's decision making.

What to expect going forward?

We reiterate that the Federal Reserve has to strike the right balance between conflicting domestic and external set of factors. We are fairly sanguine of the fact that domestic demand is likely to remain strong ensuring that the US economy grows around or just above its trend level. A robust labour market, historically low nominal interest rates and sharp increases seen in real income levels make us believe that domestic demand is likely to remain strong. The main obstacle for the Federal Reserve is likely to come from developments abroad and still soft global commodity prices that feed into price pressures and inflationary expectations in the US economy. The Fed would not want the USD to appreciate substantially given the adverse implications it poses for both the US economy and global financial stability (FX update: The USD to remain in demand, June-1-2016). Hence, *we maintain our view of a central bank cautious about international developments delivering only one rate hike of 25 bps in December-2016.*

We think that September-2016 is perhaps too early for a rate hike given that: (a) UK and EU negotiations would not have kicked off by then, (b) the Italian referendum is due in October and (c) US Presidential elections are due in November. The Fed will want these event risks to be out of the way to assess the impact on the financial markets and the USD before it considers tightening policy further.

What are the implications for the FX markets?

- **Divergence in the USD's performance:** *We see a strong case for divergence in the USD's performance against the non-commodity G-7 currencies and the EM currency block in the near-term.* We expect other major global central banks—ECB, BoE and BoJ-- to ease policy that is likely to translate into currency weakness for the EUR, JPY and the GBP against the USD.

However, the story could be very different for EM currencies in the near-term. An accommodative global monetary environment coupled with evidence of improving US data flow could mean a short-period of EM currency strength. Hence, we see some near-term downside potential across USD/EM currency pairs.

The USD could resume a more broad-based uptrend in 4Q2016 into 1H2017 when the Fed does indeed pull the trigger.

- **INR: remain a function of global risk sentiment:** We continue to expect the USD/INR pair to remain responsive to risk sentiment with a possible downside bias in the near-term of 66.50. However, we expect the RBI to intervene fairly aggressively to limit currency appreciation. Towards the end-2016 and into 1H2017 we see some depreciation setting in.
- **JPY: to respond to the BoJ's actions in the near-term:** The USD/JPY pair has already moved higher in recent weeks driven by expectations of strong monetary and fiscal stimulus measures by Japanese policymakers. The Japanese government for its part has delivered another fiscal stimulus package yesterday. The size of the stimulus package was marginally lower than expectations that limited the upside in the USD/JPY pair. However, focus is likely to be on the BoJ that is expected to step-up the quantum of stimulus measures at the conclusion of its two-day policy meeting tomorrow early morning (IST). Were the BoJ to deliver in line with expectations, there could be further upside in the USD/JPY pair.

Over the longer-term, we think that the possibility of a further divergence between US and JPY yields as the Fed tightens policy could pull the USD/JPY pair higher.

- **EUR: Further downside potential in 2016:** We maintain our call that there is further downside potential in the EUR driven by the possibility of the ECB increasing the size of its monetary stimulus and concerns about the impact that 'Brexit' is likely to have on the Euro-zone. However, we do not expect the EUR to capitulate given that a substantially high current account surplus could act as a cushion limiting the extent of downside in the pair. We see the EUR/USD pair to move towards the 1.06-1.08 range by end-2016.
- **GBP: to remain vulnerable to depreciation pressures:** We expect the GBP to weaken further. The prospect of further monetary accommodation by the BoE, softer growth prospects and a substantial current account deficit will likely result in currency depreciation.

FX forecasts						
	Jul-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
USD/INR	66.50-67.50	67.00-68.00	68.00-69.00	68.00-69.00	67.50-68.50	66.50-67.50
EUR/USD	1.09-1.11	1.0800-1.1000	1.0600-1.0800	1.0800-1.1000	1.1000-1.1200	1.1400-1.1500
GBP/USD	1.30-1.34	1.28-1.30	1.24-1.25	1.23-1.25	1.24-1.25	1.24-1.25
USD/JPY	103.00-106.00	104.00-108.00	108.00-110.00	110.00-112.00	110.00-112.00	110.00-112.00

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