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June FOMC review: the talk of talk of tapering has begun

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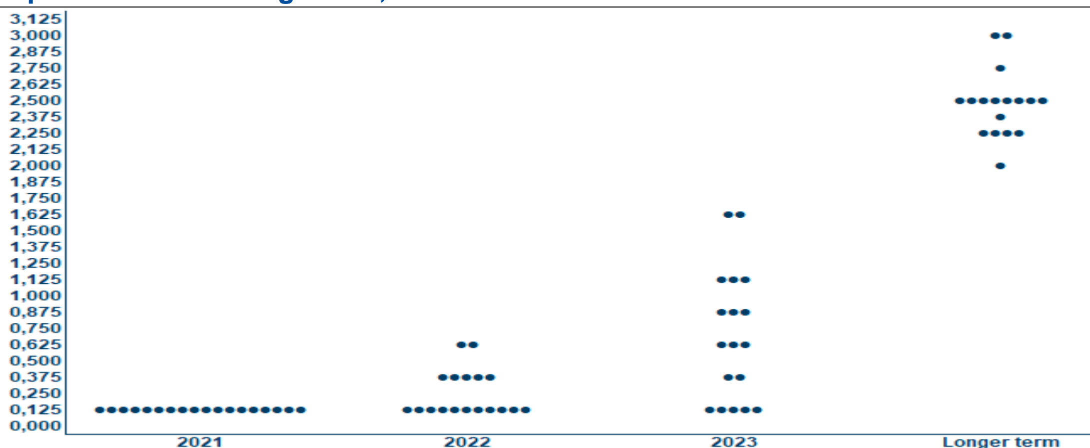
- ***FOMC statement****: little changed, with Fed maintaining that inflation remains transitory.*
- ***Dot plot****: big change to board's rate expectations, with participants now factoring in two rate hikes by end-2023.*
- ***Summary of Economic Projections****: There were no substantial changes to the 2022 and 2023 forecasts, except a sharp upward revision to 2021 GDP and inflation projections.*
- ***Press conference:*** *given fairly dovish expectations, Powell sounded slightly hawkish, warning that "inflation could turn out to be higher and more persistent than we expect".*
- ***Market reaction:*** *The markets interpreted the Fed as hawkish, sending asset prices lower across the board. The US five-year to thirty-year yield curve flattened and US Treasury yields rose across the board. US equities sold off, while the dollar index gained 0.7%.*
- ***Investment implications****: Tweaks to the statement and economic projections are a reflection of growth coming in higher than expected and inflation above target. If the US labour market rebounds more strongly and inflation remains elevated, they may pull forward their tapering cycle. We recommend a cautious exposure to US Treasuries, while favouring inflation-linked bonds with some selective positions in those sectors which are best positioned to capitalise on reopening of the economy.*

At its June meeting, the Fed kept the federal funds rate unchanged, in line with market expectations. However, the markets were a little surprised by the 5 bp hike in the interest rate on excess reserves (IOER) and the reverse repo program (RRP). The Fed described the hike in those rates as a technical move to push up short-term rates further above zero. There was little change in the FOMC statement. The only notable change was a small tweak to the inflation sentence, acknowledging the recent surge in inflation**. However, the Fed continued to describe inflation as transitory.** There was a significant change in the dot plot.

Implied Fed funds target rate, SEP



Source: Amundi, Fed Summary of Economic projections. Data as of 16 June 2021.

Fed participants now expect two rate hikes by year-end 2023 and only three dots are needed to have a rate hike in 2022. There were no meaningful changes to the Summary of Economic Projections (SEP) in 2022 and 2023. However, **there were major upward revisions to GDP and inflation forecasts in 2021.** The Fed revised its 2021 GDP mid-point forecast from 6.2% in the March SEP to 7.1% in the June SEP. The inflation mid-point projection was revised up from 2.2% to 3.0%.

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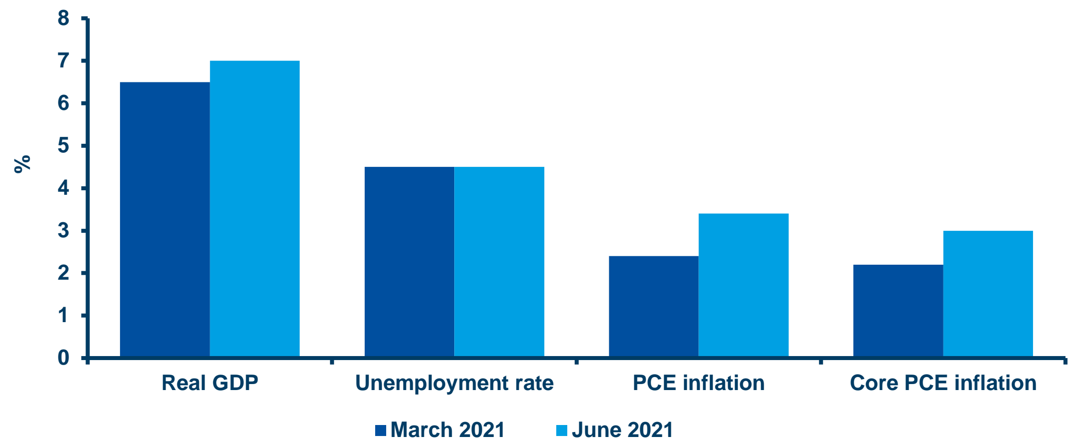
Economic projections of FOMC members for 2021



Source: Amundi, Federal Reserve. Data as of 17 June 2021.

At the press conference, **Chair Jerome Powell's tone took on a more hawkish tone than in previous press conferences**. There were three key takeaways from Chair Powell's press conference:

- He acknowledged the Fed commenced the talking about talking about tapering at this meeting. Powell stated that it would be "*appropriate to consider announcing a plan for reducing our asset purchases at a future meeting*". Consensus expected this to begin later in the summer.
- While he reiterated that the recovery is still incomplete and risks remain, he warned that inflation could turn out to be higher and more persistent than they expect.
- The labour force may take longer to recovery. The pandemic unemployment benefits, retirements, and continued concerns about Covid-19 could make it more difficult to get back to pre-pandemic employment levels. Nonetheless, the start to the rate hike cycle is still far away. It was not even discussed at this meeting.

"The markets interpreted the Fed as hawkish and that sent US asset prices lower across the board."

Market reaction

The markets interpreted the Fed as hawkish and that sent US asset prices lower across the board. The US five-year to thirty-year yield curve flattened dramatically. US Treasury yields rose across the board, with the five-year yield surging nearly 12 bp and the ten-year yield surging 8 bp to 1.58%. US equities sold off, with the Dow Jones, S&P 500 and Nasdaq indexes declining 0.77%, 0.54% and 0.24%, respectively. The dollar index gained 0.7%. European equity markets opened little changed on 17 June, with government bond yields slightly up.

Euro-dollar cross exchange rate

Source: Amundi, Bloomberg. Data as of 17 June 2021.

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Investment implications

Tweaks to the statement and economic projections are a reflection of growth coming in higher than expected and inflation above target. The Fed may be getting a little anxious with their AIT framework. If the US labour market rebounds more strongly in the coming months and inflation remains elevated, they may feel the need to pull forward their tapering cycle. **As a result, we recommend a cautious exposure to US Treasuries, while favouring inflation-linked bonds with some selective positions in those sectors which are best positioned to capitalise on reopening of the economy.**

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Definitions

- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **TIPS:** Treasury Inflation-Protected Security (TIPS) is a Treasury bond that is indexed to an inflationary gauge to protect investors from the decline in the purchasing power of their money.

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