16 June 2021
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Investment Event

Fed edging towards the exit

At the June meeting, the Federal Reserve (Fed) maintained the federal funds target range at 0.00-0.25%

Current policy appropriate

At its June meeting, the Federal Open Market Committee (FOMC) of the US Federal Reserve (Fed) left the target range for the federal funds rate at 0.00-0.25%. The Fed also maintained its guidance on the policy. Specifically, it expects to keep the federal funds target range at 0.00-0.25% until conditions are consistent with "maximum employment, and inflation has risen to 2% and is on track to moderately exceed 2% for some time". On asset purchases, the Fed will continue to buy at the current pace, or higher, until "substantial further progress has been made toward the Committee's maximum employment and price stability goals".

Growth and inflation projections were pushed up; the median expectation of FOMC members is now for two rate hikes in 2023

Beginning to talk about tapering

There were, however, material changes to the Committee's median economic projections that resulted in some FOMC members shifting forward their expectations for the timing of the first interest rate hike. The biggest revisions were to growth and inflation in 2021 with GDP now expected to increase by 7.0% (previously 6.5%) and core PCE now seen at 3.0% in Q4 (previously 2.2%). Importantly, core inflation for 2022 has also been pushed up marginally, which means it is now expected to run above the Fed's 2.0% target for three consecutive years.

As a result, the median expectation of FOMC members is now for two rate hikes coming in 2023. In March, the median expectation was for the first hike coming beyond 2023.

Table 1: FOMC median economic projections

	2021	2022	2023	Longer run
GDP (% yoy)	**7.0**	**3.3**	**2.4**	**1.8**
Mar 2021 Fed projection	*6.5*	*3.3*	*2.2*	*1.8*
Unemployment rate (%)	**4.5**	**3.8**	**3.5**	**4.0**
Mar 2021 Fed projection	*4.5*	*3.9*	*3.5*	*4.0*
Core PCE inflation (%)	**3.0**	**2.1**	**2.1**	**2.0***
Mar 2021 Fed projection	*2.2*	*2.0*	*2.1*	*2.0**
Fed funds rate (%)	**0.1**	**0.1**	**0.6**	**2.5**
Mar 2021 Fed projection	*0.1*	*0.1*	*0.1*	*2.5*

*Source: US Federal Reserve * Longer run figure is headline PCE inflation rather than core PCE*

The Committee discussed asset purchases and will have further discussions in the coming months

In his press conference, however, Chair Powell played down the projections for the funds rate, noting they were individual members' expectations, not a committee forecast. He also noted that it would be "highly premature" to discuss the timing of "lift off" for the policy rate. The main message from the projections, according to Chair Powell, was that many participants see the economy on track to meet the conditions set out in the Fed's forward guidance "somewhat sooner than previously anticipated". As a result, Chair Powell confirmed the FOMC had discussed asset purchases at this meeting and that it will have further discussions in the coming meetings. He went on to say that the Committee would provide "advanced notice" before announcing any decision on tapering.

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Our views

With the economy in an expansion phase, yields have the potential to rise further; hence, we remain underweight US government bonds.

The potential for higher yields means we are also selective in our exposure to risk assets

Macro and market considerations

US Treasury yields have moved higher since the start of 2021, increasing their prospective returns. However, with the economy in an expansion phase, yields have the potential to rise further, as they did after the June policy announcement. We therefore remain underweight.

With US inflation expectations having already risen substantially since the start of the year, the upside to nominal Treasury yields is more likely to arise from the real, inflation-adjusted, component. This “real” yield is still well below equilibrium levels and should rise as the Federal Reserve moves towards reducing the current degree of policy accommodation.

The potential for higher bond yields suggests a cautious and selective approach to risk assets is sensible given the current subdued level of expected returns following a strong year-to-date performance. In this context, exposure to the value factor continues to make sense. We like Europe and ASEAN equities as a way to access this factor. Valuations in some parts of EM fixed income, especially in China local debt, also look attractive.

We continue to expect the US dollar to weaken moderately in the near-term, reflecting loose US fiscal and monetary conditions and catch-up growth in the rest of the world. This should be supportive for emerging market fixed income. However, an earlier, or quicker, tightening by the Fed could put upward pressure on the dollar. Other risks include the possibility of a faster pace of credit tightening in China, which could weigh on global growth and lead to dollar strength.

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