THIS MONTH'S TOPIC

DM monetary policies are at a crossroads

Central banks have put in place ultra-accommodative monetary policies to support economies during the Covid crisis. The strong recovery taking shape in developed economies should allow a gradual reduction in monetary support. As a strategic element of global financing conditions, the Fed's monetary policy normalisation is gaining attention.
In developed economies, the rebound in economic activity should allow central banks, first, to gradually reduce purchasing programs and, second, to raise rates. The Bank of England and the Bank of Canada have already made "tapering" announcements. We expect the Fed to follow suit.

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The Fed's determination to let the US economy run hot is the biggest difference in this cycle compared to post-2008. A sustainable economic rebound is the priority. The Fed changed its policy framework with a determination to stay behind the curve. The new strategy puts more weight on bolstering the labour market and less on worries about inflation that is too high:

- **The Fed has redefined its inflation goal in terms of the average rate of inflation,** rather than the rate of inflation at any given point in time. "The Committee seeks to achieve inflation that averages 2% over time, and therefore judges that, following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time."
- **The labour market is the priority.** Full employment is defined as "a broad-based and inclusive goal". The new policy statement pledges that the US central bank will make policy decisions based on "shortfalls" with regard to full employment.

These two major changes in its monetary policy framework have two consequences:

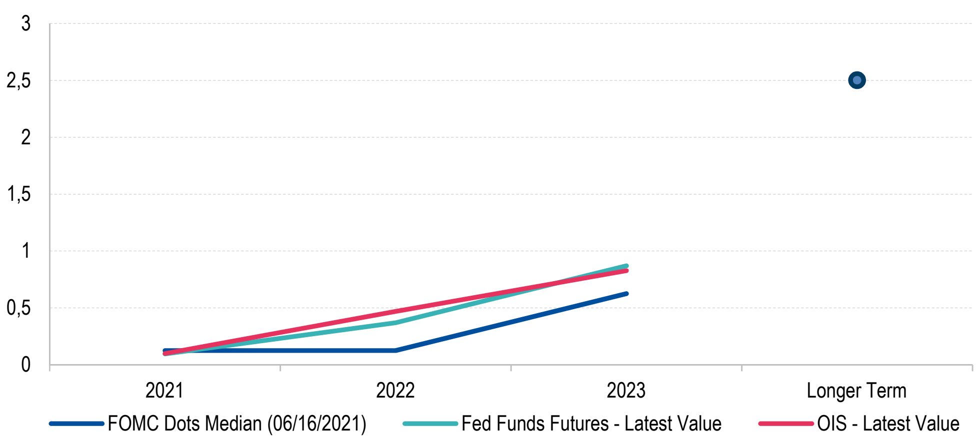
- **The Fed will keep rates low for longer.** Jerome Powell stressed that the Fed will not act pre-emptively and that an increase in rates would be possible under certain conditions: (1) maximum employment, (2) inflation reaching and staying at 2%, and (3) inflation increasing moderately above 2% for a certain length of time.
- **The timing of the tapering will depend on labour market trends.** We expect the Fed to keep a prudent tone concerning any change in its QE policy. Purchases will continue at least at the current pace (USD 80bn of Treasuries and USD 40bn of MBS per month) "until substantial further progress has been made toward the Committee's maximum employment and price stability goals". Powell reiterated that any reduction in the asset purchase program would be "clearly communicated well in advance".

What do the latest communications from the Fed tell us?

- **The Fed has struck a positive tone on the economic outlook**. "Indicators of economic activity and employment have continued to strengthen." "The sectors most adversely affected by the pandemic remain weak, but have shown improvement." Powell also remained optimistic on the labour market, despite some near-term weakness. The Fed is expecting a very strong labour market: "factors related to the pandemic, such as caregiving needs, ongoing fears of

The rebound in economic activity should allow the Fed to reduce its asset purchase program

1/ **Implied Fed Funds target rates**



Source: Bloomberg, Amundi Research - Data as of 25/06/2021

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"It is going to be a very strong labour market" (Jerome Powell)

The dollar is key

In 2020, the huge liquidity injection (with more than USD 5trn liquidity pumped into the system) and the deteriorating US fiscal and trade position have coupled with a quite elevated greenback overvaluation and implied a persistent USD sell-off.

Back in Q1 2021, we argued that conditions for a mild USD bull-run were realigning, as fiscal loosening was pointing to higher US growth advantage and as US rates had started accelerating faster than in the rest of the world. Unlike what we saw in 2020 in fact, US real rates started climbing with US break-evens, and that is one of the key catalysts to start accumulating the USD, in our view. Something the disappointing labour market dynamics and the perceived Fed commitment to its transitory inflation narrative began challenging in April.

However, the Fed is now preparing the ground for the normalisation of its QE policy, as it remains confident in the economic outlook. We expect the Fed to start to reduce its QE by 2022 and while Dots suggest two-rate hikes starting in 2023, data releases will be back on investors' focus, thus shortening the FED's forward guidance and adding volatility. US nominal rates remained low, even more than Break-evens. Indeed, mid- and front-end nominal rates have room for adjustments should data confirm what expectations point to today. In that scenario, the USD would strengthen against the entire board. We see that starting with low-yielders to include high-yielders when inflation expectations deteriorate.

This is something we see as consistent with the rising USD exceptionalism narrative in fact. If the US twin deficits are big in size and often translate into currency depreciation in the medium run, we see both growth and carry advantage proving strong enough to sustain the USD rather than to prevent its rebound. Those conditions were able to offset the USD overvaluation in the recent past and the fact that today the currency seems almost fairly priced with respect to fundamentals (after the 2020 correction, the USD is only 2% above its average fair valuation),we believe they will matter even more.

the virus, and unemployment insurance payments appear to be weighing on employment growth. These factors should wane in the coming months against a backdrop of rising vaccinations, leading to more rapid gains in employment."

- **The Fed continues to view the rise in inflation as temporary, but it is ready to act.** Bottleneck effects have been greater than expected, and FOMC participants have revised upward their projection for core inflation for this year (3% compared to 2.2%). As these transitory supply effects abate, inflation is expected to pull back in 2022 and 2023 into a range "between 2% and 2.3%, which is consistent with (the Fed's) goals". However, some members appeared increasingly concerned about inflation and less confident that inflation will recede in 2022, remarking that supply chain bottlenecks and input shortages may not be resolved quickly and could put upward pressure on prices beyond this year.
- **The Fed is now preparing the ground for the normalisation of its QE policy.** If the economy continues to make rapid progress, the Fed considers it will be appropriate to consider announcing a plan for reducing asset purchases at a future meeting. We expect the Fed to remain very cautious for two reasons: (1) "any policy change will be communicated to the market well in advance"; and (2) the slowdown in purchases will be very progressive.
- **According to the dots, Fed officials expect to start raising interest rates in 2023.** We should not give dots too much credit. According to Powell: "the dots are not a great forecaster of future rate moves". "These are, of course, individual projections." "They are not a plan." In addition, "rate increases are really not at all the focus of the committee". "The near-term thing is really a discussion that will begin about the path of asset purchases".

Very accommodative monetary policy is not a free lunch

The Fed's monetary policy normalisation is focusing attention:

- **If the economy continues to make rapid progress, we anticipate a gradual reduction in the Fed's purchasing program from the first quarter of 2022.** Very accommodative monetary policy is not a free lunch. Some FOMC members have already voiced concerns regarding financial stability, stressing the risk that the prolonged period of low interest rates and highly accommodative financial market conditions could lead to reach-for-yield behaviour that could raise financial stability risks.

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"The dots are not a great forecaster of future rate moves" (Jerome Powell)

- **Regarding rates, two scenarios:**
  1. **If the Federal Reserve's benign view on inflation prevails, employment will be key.** Disappointment in growth, persistence of the public health crisis, or a sharp correction in the financial markets would force the Fed to maintain its support. Rates only will be raised if inflation and the labour market target are met.
  2. **However, if inflation runs too high, the Fed may be forced to tighten monetary policy faster than it wants to.** The Fed is clear: it is ready to act "if inflation or inflation expectations significantly and persistently exceed what it sees as its long-term goals", "Price stability is half of our mandate". The big risk remains on potential inflationary pressure that could result from a tightening of resource utilisation across the whole economy.

The strong recovery expected in the United States should allow a gradual reduction in the Fed's asset purchase program from the first quarter of 2022. In this context, we expect higher US real rates, supporting the US dollar. Nonetheless, the potential normalisation of US monetary policy will be limited by record levels of US sovereign and corporate debt and very tight asset valuations. The effects of a US policy tightening could also manifest themselves abroad via declines in international risky asset prices, tighter financial conditions and capital outflows. The US policy tightening has been shown to affect emerging economies more forcefully than advanced economies.

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