September FOMC Preview and Market Implications

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We want that Tapering: Its September then, then November, December, What?

Okay… this subtitle will take a little bit of explaining but for those familiar with that catchy tune by Riton & Nightcrawlers feat. Mufasa & Hypeman, you will know what I mean. A modification and an ode to tapering of the intro of that song would go like: You know we finally here, right? Where are we? It's taper time… if we do not get it in September then its either in November or December, what?

This is what tapering has come down to, guessing which month they finally go ahead with the most televised Fed action in history. If the Fed truly wants to separate tapering from tightening they need to just get on with it. However something tells me that given recent price action and uneven data they will still lean on the dovish side, i.e. give us enough guidance without delivering the full taper news.

This meeting is also critical given that we will get the 2024 dots and an update for all the prior years as well, with 2022 being a close call of coming in at 1 hike. The statement will also need a re-writing to suggest that "substantial further progress" has been made on the labor markets (so expect that phrase to drop). It will also be interesting to see how far they can stretch the transitory inflation line.

Bottom-line: Thus far the Fed has been able to avoid a 2013 taper tantrum repeat by stretching out the taper discussion and eventual implemention of their tapering plans. However signs of excess liquidity are everywhere (from the swollen RRP usage to tight spreads and high valuations in risk assets) so the jury is still out for what takes place once tapering is in motion. That however is not the focus of this meeting. The focus at this meeting is the 2024 dots, statement language adjustments (is inflation still transitory and how about the slowing of the economy lately, also transitory), taper and Powell's Presser (and expect questions on China and the debt ceiling)…

FOMC MARKET SCENARIOS

The last Fed meeting had a slightly hawkish tilt in the statement (characterizing the economy is in a strengthening period) and chair Powell was more upbeat during his press conference too and even downplayed the impact of future CV19 waves on the economy. Yet rates barely moved on the day at the July meeting with 5s30s experiencing a minor flattening twist. At this juncture I feel there is more at risk and depending on what tone is struck, markets may move more, closer to what we saw in June meeting, I lean hawkish.

- *Dovish scenario (15% chance):* Fed basically does not make any changes to rates, the 2024 dot has just 1 hike, and no specifics given on taper. In such a scenario vols will come off, belly rates rally and credit spreads and risk assets perform into quarter-end.
- *Neutral scenario (55% chance):* After having adjusted RRP rates and setting up the standing repo facility (SRF), the Fed is ready to taper but does not provide the breakdowns or starting date, instead states that before year-end the Fed is preparing to reduce the pace of QE purchases. They do not collectively raise the 2022 dot dampening fears of a faster hiking campaign lies ahead.
- *Hawkish scenario (20% chance):* The 2022 submission end up tipping the scales toward 1 median hike projected that year and the 2024 dots have 2 or more hikes built into that terminal rate as well. 5s would come under pressure as the curve flattens.
- *Uber-hawkish scenario (10%):* Take the hawkish scenario and add in the actual launch of the tapering, and starts up in October.

Comparing the actual last three FOMC meeting market moves and average cross-market changes for FOMC events (based on five years of historical data)

	Bills (bp)				Coupons (bp)				Curves (bp)		TIPS (bp)	Vol (bpv)	FX (%)		Risk Market	
	1m	3m	6m	1y	2yr	5yr	10yr	30yr	2s10s	5s30s	10yr Real	1y10y vol	Euro	Yen	SPX	IG Spreads
7/28/2021	(0.3)	0.1	0.1	0.1	(0.2)	1.2	(0.8)	(1.3)	(0.7)	(2.6)	(4.7)	(1.3)	0.2%	0.1%	0.0%	(1.1)
6/16/2021	1.3	1.2	0.7	1.4	4.2	11.5	8.3	2.1	4.1	(9.4)	15.1	0.4	-1.1%	0.6%	-0.5%	(1.6)
4/28/2021	2.8	0.6	(0.3)	(0.3)	(1.6)	(3.1)	(1.2)	(0.5)	0.3	2.5	(3.0)	(0.1)	0.3%	-0.1%	-0.1%	0.0
Avg Chg day	(2.1)	(1.7)	(1.6)	(0.9)	(1.8)	(2.5)	(2.7)	(2.8)	(0.9)	(0.3)	(1.8)	(0.7)	0.1%	-0.2%	-0.4%	0.5
Avg 1-day post	(1.5)	(0.8)	(0.8)	(0.6)	0.1	1.0	1.2	1.0	1.0	(0.0)	1.6	0.0	-0.1%	0.0%	0.0%	0.5
Avg 5-day post	(0.7)	(1.1)	(1.4)	(3.6)	(2.9)	(2.4)	(1.8)	(1.6)	1.1	0.8	(0.6)	0.6	-0.2%	-0.1%	-0.6%	3.7

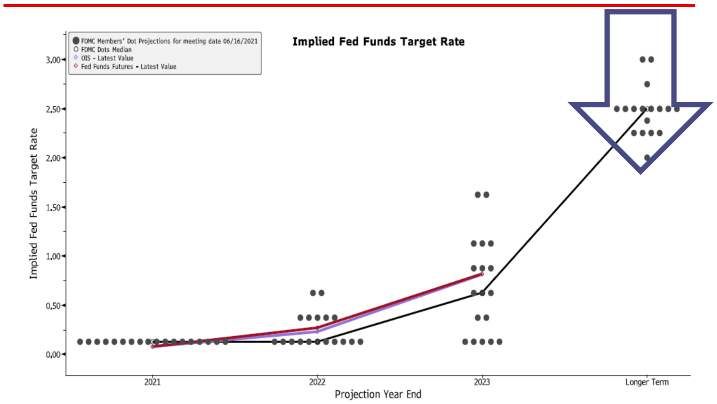
Source: Bloomberg and MUFG U.S. Macro Strategy

FED SEP VIEWS: ALL ABOUT THE DOTS & HOW THEY MARK-TO-MARKET WHAT FEELS LIKE PERSISTENT INFLATION

The Dots: Although there has been much consternation over the Fed's tapering plans all year long, if one goes back and looks at the largest contributor of rate moves at the recent Fed meetings it was actually the lifting of the '23 dots (to suggest 2 hikes) that were updated at the June meeting that led to major rate market moves, especially in the belly. At the September meeting we will get updates for all the future terminal rate (median dots) forecast as well as the introduction of the 2024 rate expectations. I do not think there is major changes done to the 2023 dots so I am focusing on the 2022 and the new 2024 dots. Before I go there, don't you find it interesting that the long-run dots cloud looks like an upside down arrow, maybe a sign of what is yet to come? I digress.

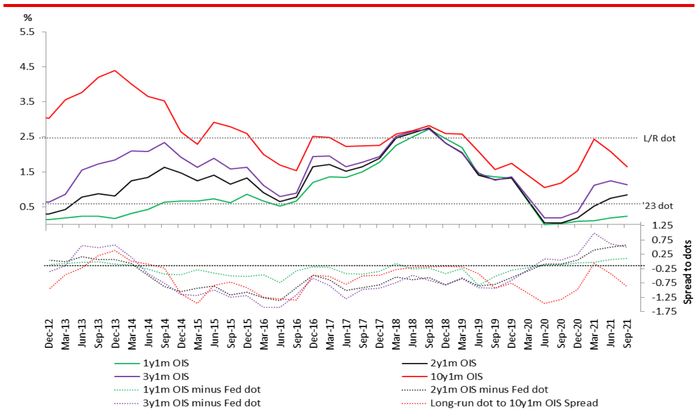
It's a close call on the 2022 dots, but as our [fx strategists suggest] it would only take 3 FOMC members to raise their dots for the median dot to go to one hike in 2022. Given the clustering of forecasts in 2023, its possible that a similar grouping is formed for 2024 and that would put the 2024 dot closer to 1.125%, suggesting two more hikes then. This would be suggestive of a proper rate hiking campaign of 2 hikes per year for two years running. If the broader FOMC committee wants to deliver a dovish taper I think they would only project 1 hike in 2024 and again no hikes in 2022 just yet as they can always raise the dot estimates next year.

The dots are back in focus: watch the 2022 & 2024 moves



Source: Bloomberg DOTS, MUFG US Macro Strategy

Forwards 1M terminal rates and their spread to the dots

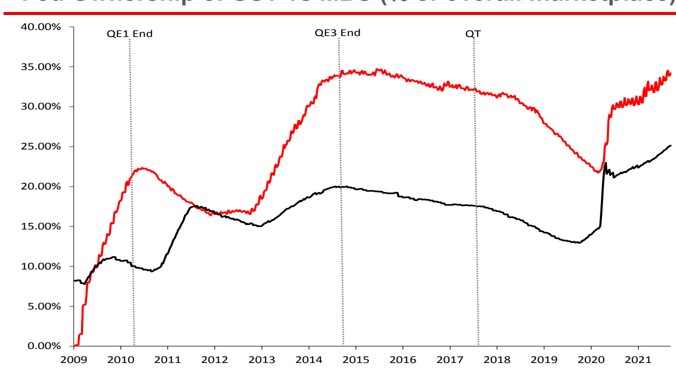


Source: Bloomberg, MUFG US Macro Strategy

FED BALANCE-SHEET POLICY OUTLOOK: TAPERING IS IN THE AIR, MAYBE JUST GUIDANCE OR THEY FINALLY DO IT!

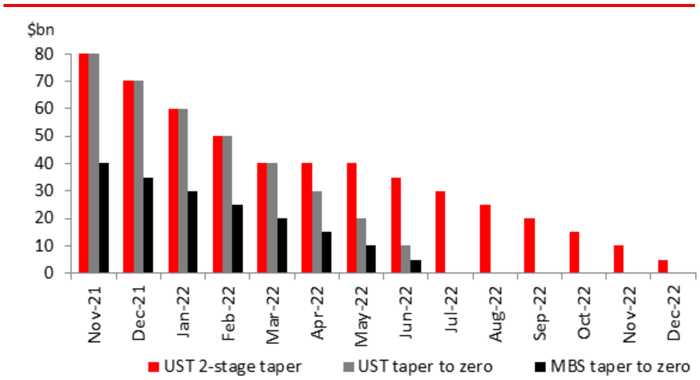
Taper time: This will likely go down as the most well televised change in Fed policy in history. So kudos for the Fed in their attempt at making tapering a non-event. That said its always easier to talk about taking action versus delivering on it. I still am of the view that all this marginal excess liquidity has boosted risk assets and we will only know the counterfactual once they get at least half way through the tapering. Also as I have said before, each meeting now is live until we get the taper, so its always possible that the FOMC gives us enough information at the September meeting that it ends up being the tapering announcement. Alternatively, which is my base case, they give guidance but buy optionality to deliver the final plans at either the November (my base case given the OMOs calendar) or December meeting or in their parlance "sometime before year-end" starting in November with $15 bn proportional monthly decline would have them wrap up taper by summer 2022. However if there was a material slowing of the economy or some other exogenous event, I am of the view they could let MBS taper continue (given they own so much of that market) and keep buying USTs at a smaller scale. This 2-stage tapering of pausing/restarting would give them more flexibility.

Fed Ownership of UST vs MBS (% of overall marketplace)



Source: Bloomberg, MUFG US Macro Strategy

Fed Tapering: Start in November, keep flexibility to pause



Source: Bloomberg, MUFG US Macro Strategy

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