SEPTEMBER 2020 FOMC MEETING

17.09.2020

Backdrop

Market expectations ahead of yesterday's FOMC meeting were largely in favour of a statement similar to what we have seen so far this quarter. Short-rate markets were pricing the federal funds rate to remain at 0.0%-0.25% until the end of 2023, indicating that the revised Fed "dot" plot would point to no rate hikes for the foreseeable future. The main expected change was a move in the Fed's inflation objective from a "symmetric 2% inflation objective" to an "inflation that averages 2% over time", with possible precision regarding the time horizon.

Indeed, the Fed confirmed its accommodative stance, keeping interest rates unchanged, indicating no rate hikes are expected until 2023 at the earliest and confirming that it will continue asset purchases "at least at the current pace". The market was also proven right in terms of the inflation objective expectations, with the Fed confirming the change in its statement. The FOMC also revised its economic scenario, upgrading its growth projection for 2020 from -6.5% to -3.7% while lowering its 2021-2022 forecasts by 1.5% in total. Unemployment rate projections improved: 2020 numbers were expected to be around 9.3%, but have now been revised to around 7.6%. Inflation projections were also upgraded, though inflation is not expected to climb back to 2% before 2023.

In spite of the improvement in economic expectations, 2020 is still expected to remain a recessionary year and the US economy is still expected to take years to recover from the shock, as was made very clear in the statement: "The ongoing public health crisis will continue to weigh on economic activity." Consequently, the "dot" plot has not been revised and 2023 projections confirmed the market's expectations: inflation is not expected to exceed 2% in the foreseeable future, thereby justifying the no rate hike stance given the Fed's new objective.

In a nutshell, the macro picture remains bad for 2020 but has improved since June, though without giving any signal to the Fed that it needs to change the course of its accommodative policy. However, most speakers are calling for increased fiscal support as an absolute prerequisite to prolong the recovery into long-term positive growth. Interestingly, two dissents voiced concerns that they would want either more flexibility or a stronger commitment to seeing core inflation higher. Whichever way we read the statement, it is one of the most dovish positionings from the Fed since the Great Financial Crisis.

Market Impact

The overall dovish tone was initially well received by risky markets. Following the statement's release, Treasuries were little changed, with the 10-year yield steady at about 0.68%, while stocks gained slightly. All in all, the statement and projection seemed well anticipated by markets.

Asset Allocation Consequences

Monetary and fiscal responses following the COVID-19 crisis have been unprecedented in size and scale. Today's Fed meeting was further evidence that central banks will continue to do "whatever it takes," supporting risk premia broadly. The Fed is ahead of its peers with its balance sheet now in excess of USD 7tn, paving the way for other central banks and explaining the limited short USD position that we maintain. The change in its objective is another indication that the bond markets should become increasingly uneventful while making the equity one more attractive. With this in mind, our current dynamic assessment articulates around three dimensions:

Macro: Growth remains solid and inflation is nowhere to be found. The longer picture is supportive for growth assets.

Market Sentiment: Sentiment remains positive for growth assets broadly. However, we think it could prove more difficult for high yield as positioning there is already stretched.

Valuation: Valuations reflect lower rates and ongoing macro trends: equities are not yet expensive. We see credit pricing as overly optimistic.

From these three elements, our current dynamic allocation highlights that we should remain positive on growth-oriented assets but be more selective than in the past because of stretched valuations and higher positioning.

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