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Daiwa Securities

Daiwa's View

Fed's easing of forward guidance a cause of rise in yields

➢ Will Fed opt against additional easing in September?

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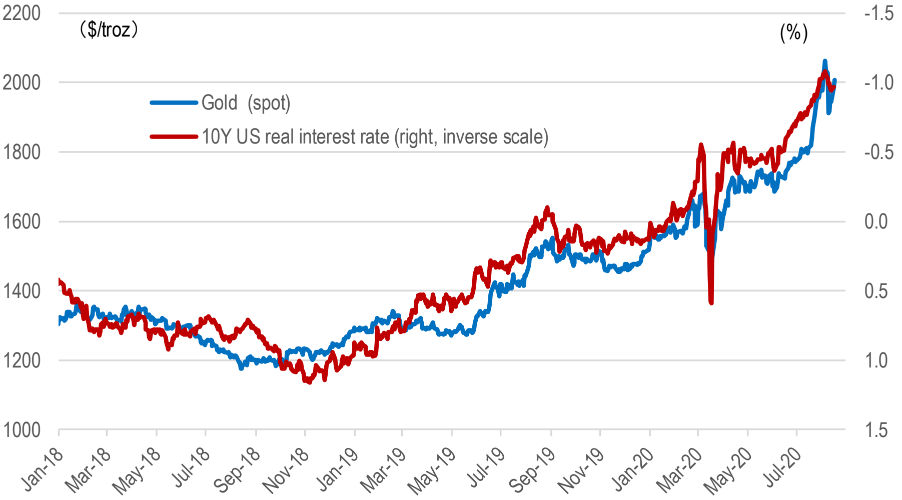
Fed's easing of forward guidance a cause of rise in yields

Will Fed opt against additional easing in September?

We have explained on multiple occasions what has been behind the sharp rise in US interest rates over the past 10 days or so. In a nutshell, we think multiple factors, rather than a single factor, explain the rise. This time of year is particularly sensitive to supply-demand factors, and a short-term worsening of supply-demand, caused in part by corporate bond issuance, was probably a significant factor. It is also true, however, that the recent broad trend of declining real interest rates bottomed on 6 August.

Leaving it up to our chief strategist Mr. Tani to explain detailed daily movements, we concern ourselves here with what the fundamentals have done since real interest rates bottomed, which is that on 7 August the US jobs report beat market expectations and President Trump announced four executive orders that delayed the pending fiscal cliff. In addition, some strong inflation numbers were announced last week, the PPI on 11 August and the CPI on the 12th. Adding further fuel to the fire were a series of comments on monetary policy from Fed officials.

Gold Price, 10Y US Real Interest Rate



Source: Bloomberg; compiled by Daiwa Securities.

Those comments fueled speculation that the Fed may put off making the additional policy moves that had been expected at its next FOMC meeting in September. For example, on 12 August San Francisco Fed President Mary Daly remarked that she saw no need for additional guidance "right now," while Boston Fed President Eric Rosengren said that any change in forward guidance would be meaningless at this point.

Even Minneapolis Fed president Neel Kashkari, who is known as a dove, said on 14 August that there is not a lot the Fed can do until the virus is brought under control. Asked about changes to forward guidance, he said he thought that was a possibility in the future but the Fed is well-positioned now based on the actions it has taken thus far. Thus multiple Fed officials, including dovish ones, have distanced themselves from the idea of taking additional actions aimed at strengthening forward guidance at this point.

◆ **San Francisco Fed President Mary Daly** (12 August 2020)

・The US economic recovery is likely to be W-shaped and tail off in waves. Because the pandemic is not yet under control, the road ahead will probably be a difficult one. There is no need for additional forward guidance right now. This is currently very clear, and I do not think such additional actions are needed. I expect the time will come when further clarity is needed and I will support that, and I think research shows that would be effective. If the additional unemployment benefits are not extended, there is a possibility it will open a hole in the economy.

◆ **Boston Fed President Eric Rosengren** (12 August 2020)

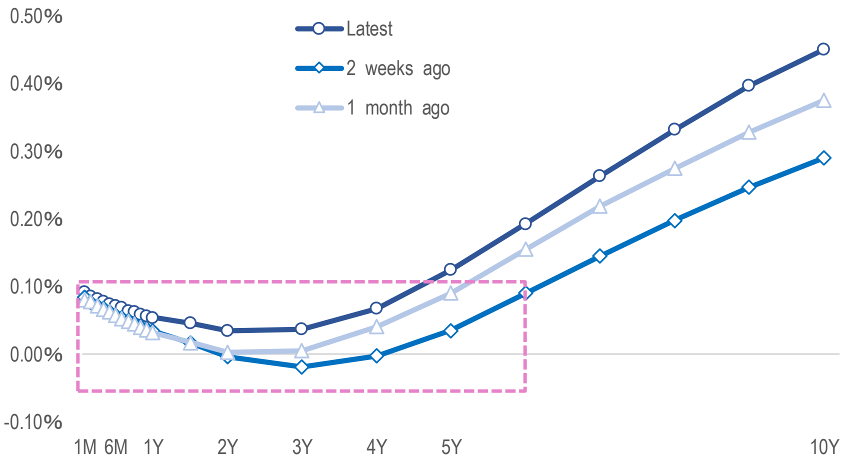
・(Asked about revisions to forward guidance,) that would be of little use at this point. There is probably an appropriate time for forward guidance. At this stage in the recession and pandemic, forward guidance is unlikely to be of much use. People already think that it will take quite some time before interest rates start rising again.

◆ **Minneapolis Fed President Neel Kashkari** (14 August 2020)

・The trend in the virus will determine the trend in the economy. Accordingly, the most important thing anyone can do is get the virus under control. Until it is, I am not confident that there are many things that the Fed still needs to do at this point. There will probably be more the Fed can do once the virus is brought under control, people return to work, and the economy is aggressively reopened to the maximum extent possible. (Asked about revisions to forward guidance), he said he thought that was a possibility in the future but the Fed is well-positioned now based on the actions it has taken thus far.

These comments shook up (created a backlash in) the outlook for Fed monetary policy held by the market, which had been pricing in negative interest rates since the July FOMC meeting[1]. In other words, most market participants expected the Fed to announce the results of a strategic review of its monetary policy framework at the September FOMC meeting and at the same time unveil a package of easing measures, specifically a strengthening of forward guidance and open-ended asset purchases (QE), but it has now become much more likely that it will put off doing the latter (additional easing)[2].

US OIS



Source: Bloomberg; compiled by Daiwa Securities.

[1] Some of this was a correction of an overshoot.

[2] Although we think most observers still think the most likely scenario is the Fed announcing at its September FOMC meeting the conclusions from its strategic review together with additional measures to strengthen forward guidance, we think the subjective probability of the latter has declined. In contrast, no FOMC member has yet suggested that the Fed will delay announcing conclusions from its strategic review.

We have had many inquiries regarding this, along with some misunderstandings, and to expand on that, we address this as two separate issues: the strategic review of its monetary policy framework and the additional policy measures aimed at strengthening forward guidance. The strategic review is a long-term (during ordinary times) discussion aimed at conducting a comprehensive review of monetary policy strategy and methods as well as means of communication[3]. It has nearly reached a conclusion, which the consensus believes will entail shifting to a makeup strategy comprising soft average inflation targets[4].

Additionally, the tools of quantitative easing (QE) and forward guidance, like yield curve control, relate to tactics. The strategic review should provide a positive assessment of these tools as effective tools for future easing.

Such an assessment does not necessarily mean that a strengthening of forward guidance at the September FOMC meeting is inevitable, however. Even still, the reason that many market participants, including your author, had expected the Fed to announce specific measures at its September policy meeting, namely forward guidance tied to an inflation target along with open-ended QE, is that taking action makes it possible to ensure the effectiveness of its change in framework[5]. Most of the Fed's communication had been along those lines.

◆ **Minutes of FOMC Meeting on 9-10 June** (1 July 2020)

・Most participants commented that the Committee should communicate a more explicit form of forward guidance for the path of the federal funds rate and provide more clarity regarding purchases of Treasury securities and agency MBS as more information about the trajectory of the economy becomes available. A number of participants judged that it was important for forward guidance and asset purchases to be structured in a way that provides the accommodation necessary to support rapid economic recovery and fosters a durable return of inflation and inflation expectations to levels consistent with the Committee's symmetric 2 percent objective. Many participants remarked that the completion of the monetary policy framework review, together with the announcement of the conclusions arising from the review and the release of a revised Committee statement on its goals and policy strategy, would help clarify further how the Committee intends to conduct monetary policy going forward.

So what explains the change in message in which multiple Fed officials have begun suggesting that the Fed will delay making additional policy moves aimed at strengthening forward guidance? Although it sounds paradoxical, we attribute it to the economic outlook's increased uncertainty.

In fact, San Francisco Fed President Mary Daly now has a more pessimistic view of the economy, as evidenced by her comment that the US economic recovery is likely to be W-shaped and tail off in waves. Remarks from other Fed officials struck a common theme, noting the weakness of economic activity shown in the high-frequency data while expressing concern over the uncertainty affecting discussions of additional economic measures. According to Minneapolis Fed president Neel Kashkari, "there is not a lot the Fed can do right now."

◆ **Boston Fed President Eric Rosengren** (12 August 2020)

・Limited or inconsistent efforts by the states to control the virus based on public health guidelines not only expose the population to the unnecessary risk of life-threatening illness but are likely to prolong the economic slump. The forecast for this fall is quite uncertain, but my view is that the recent slowdown in economic activity (as shown by high-frequency data) is likely to continue.

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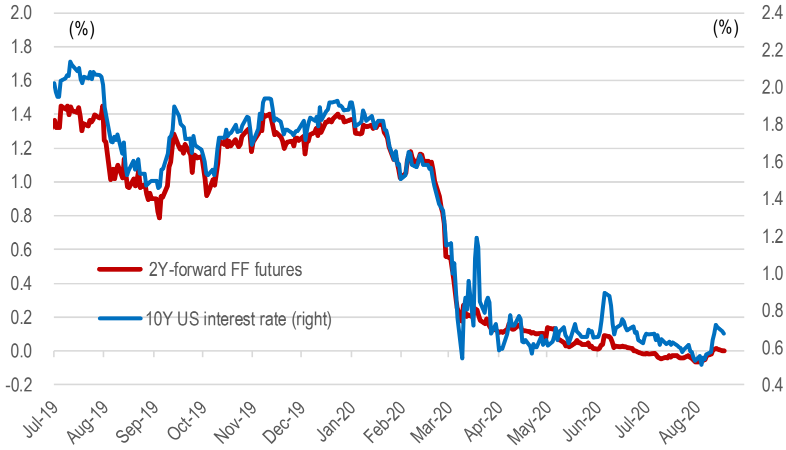
[3] This had actually been discussed since long before the pandemic began but was temporarily suspended during the pandemic.
[4] We plan to discuss average inflation targets in detail separately.
[5] In fact, the average inflation target (strategy) is very compatible with a forward guidance (tool) that commits to overshooting 2% inflation, and many FOMC participants "spoke favorably of forward guidance tied to outcomes," according to the June FOMC minutes.

This seems obvious when you think about it. Forward guidance aims to extract the benefits of monetary easing during an economic recovery (when the clouds have begun to clear) by lowering the market's policy rate expectation below what the fundamentals suggest. In fact, Fed Chair Jerome Powell and Fed Vice Chair Richard Clarida, as well as other Fed officials, have repeatedly stated, based on the economy beginning to recover in the second half of 2020 being the most likely scenario, that because they will have a deeper understanding of the economy's trajectory going into the fall, they will consider additional policy measures at that time.

In other words, because the above-noted message from Fed officials is a consequence not of optimism over the economy but rather of increased economic uncertainty (it has become more cloudy), it is holding in reserve its option of pursuing (i.e., delaying) additional easing. Although President Trump's signing of executive orders instructing additional fiscal stimulus reduces near-term risks, it actually does more to increase uncertainty by removing any incentive for Congress to quickly reach an agreement (compromise)[6]. As this also makes clear, is important to note that the time frame for the Fed's forward guidance has not been shortened[7].

Although the market expects the two political parties to eventually reach an agreement on additional economic stimulus, it has now become more likely that will not happen until September or later. The debate over additional economic stimulus and what it eventually includes will have a major impact not only on the economic outlook of individual FOMC members but also on the decisions made at the September FOMC meeting. The Fed will keep an eye on the latest economic data while trying to affect market expectations leading up to its September policy meeting. The July FOMC minutes to be announced this week should provide details of its discussion about the strategic review as well as some hints as to if and how it will implement additional easing.

US 10Y Interest Rate, 2Y-forward FF Rate



Source: Bloomberg; compiled by Daiwa Securities.

6 The general understanding is that any economic stimulus from President Trump's latest executive orders would be too small, if implemented.
7 As indicated by the comments from Fed officials noted above, forward guidance is currently qualitative in nature, i.e. "the Fed will maintain current targeted range until committee members are confident that the economy is on track to overcome recent events and achieve its goals of maximum employment and price stability," and these policy goals are being sufficiently communicated.

Daiwa Securities

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[Standard & Poor's]

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