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FOMC July Meeting Preview: Will Powell hint at yield curve control?

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Will Powell hint at yield curve control this week?

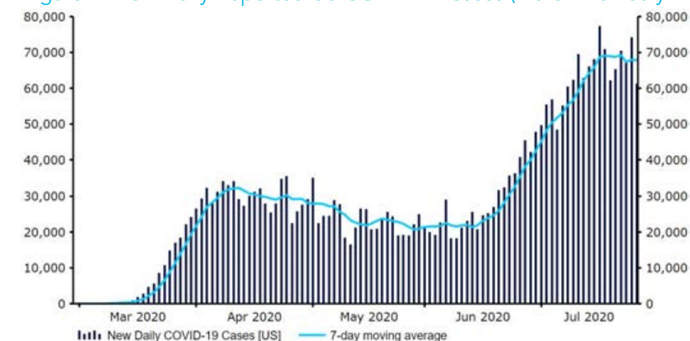
As financial markets stabilise and the US economy shows signs of recovery, the Federal Reserve is set to leave its monetary policy unchanged at its meeting on Wednesday.

The Federal Reserve has delivered an aggressive response to the current crisis, announcing an unprecedented set of stimulus measures designed to calm markets and support the US economy. This included cutting interest rates to practically zero and pledging to purchase an unlimited amount of bonds to drive down interest rates and keep financing costs low. These measures, unleashed in tandem with a large fiscal response from the US government, have helped calm the markets and deliver meaningful improvements in US economic data.

Financial markets have bounced back from their virus-induced sell-off. The S&P 500 index is currently trading more-or-less unchanged for the year, having rallied by over 40% since its lows in March. Macroeconomic data has also shown broad improvements, in part due to the large state and central bank response and the unwinding of lockdown measures. Leading indicators of business activity (the PMIs) have rebounded well, while measures of consumer spending activity have improved, notably the better-than-expected set of June retail sales figures. This has raised hopes that the US economy may be experiencing a recovery that resembles a 'V-shape', where it returns to pre-lockdown levels at a faster pace than initially anticipated.

The big cause for concern for policymakers will be the continued increase in new US virus cases. New reported cases of the COVID-19 virus have hit fresh daily highs throughout the month of July (Figure 1), with a host of states backtracking on plans to re-open their economies. We have begun to see this translated into a worsening in labour market conditions, with initial jobless claims increasing for the first time since March in the week to 17th July. The possibility of prolonged lockdown measures, combined with the lack of agreement in Congress on extending the $600 a week additional unemployment insurance benefit scheme, present a significant downside risk to the recovery. The latter is set to expire at the end of July, with a best-case scenario to see additional income support significantly reduced, if extended at all.

Figure 1: New Daily Reported US COVID-19 Cases (March '20 - July '20)

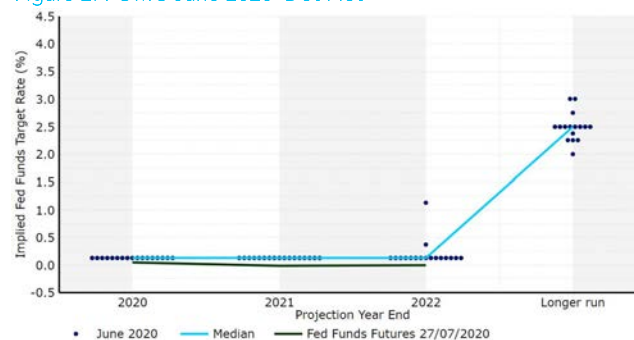


Source: Refinitiv Datastream Date: 28/07/2020

The question now is what can the Fed do to continue supporting the US economy as it claws its way out of the worst downturn in decades. We think that while the Fed will mention the recent improvements witnessed in US data, it will likely strike a cautious note over the recovery, highlighting the significant downside risks that remain.

We also expect policymakers to continue stressing that interest rates will remain at current record low levels for the foreseeable future. The Fed suggested in its June 'dot plot' that no change in rates was likely before the end of 2022 (Figure 2). We see little that would warrant a change in stance from the Fed at this stage, and expect the bank to make it clear once again that rates are not going anywhere any time soon.

Figure 2: FOMC June 2020 'Dot Plot'



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Aside from that, markets will be paying close attention to Chair Jerome Powell's comments on the use of more unconventional monetary policy tools. There has been a lot of talk in the markets about the Fed implementing yield curve control, similar to that used by the Bank of Japan to keep long-term borrowing costs below a specific level or range. We do not think that the Fed will introduce such measures just yet. The yield on the US 10-year government bond is already near record lows at below 0.6% - perhaps partly in expectation that yield curve control may be on the horizon. For this reason, we expect Powell to keep open the possibility of implementing the programme later down the line, with a reluctance to do so likely to have the undesired effect of pushing yields higher.

Overall, we think that the Fed will keep its policy unchanged this week, while striking a cautious note over the outlook for the US economy. As mentioned, we expect Powell to keep the door ajar to the use of yield-curve control later this year, should it deem conditions warrant such action. The reaction in the FX market to this will be an interesting one. Should the trend during the current crisis of more stimulus, stronger domestic currency continue, then the dollar would likely rally. Whereas a sell-off in the dollar to the prospect of more central bank easing could mark a return to the conventional market reaction. That being said, with the US government still yet to agree on whether to extend its income support measures, the Fed may sit tight and try to keep a low profile while it awaits news out of Congress.

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