

Market pricing going into Powell testimony

- 60bps of easing remains priced in this year, even after the yield back-up
- Neutral is an emphasis on downside risks and willingness to accommodate
- Dovish is an emphasis on downside inflation and growth risks
- Hawkish is anything that suggests one 25bps cut and no more

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The market has about two and a half 25bps Fed cuts priced in by year-end, down from three-plus a couple of weeks ago. In our view, the market is pricing in roughly one and a half to two 25bps cuts due to weak inflation and one half to one due to the risk of economic weakness. Bond yields have backed up c.10bps since their lows. Investors will look for signals from Powell that further easing is likely beyond July.

Steve Englander
+1 212 667 0564
Steve.Englander@sc.com
Head, Global G10 FX Research and North
America Macro Strategy
Standard Chartered Bank NY Branch

On a dovish surprise, the big mover is likely to be rates to the downside, followed by equities to the upside. Investors tend to lean towards low rates, but they cut positions after the strong US non-payroll (NFP) release. They would likely respond quickly if encouraged by the Fed. Equities would likely bounce as well, but equities face headwinds other than rates, so a fixed-income move could be more definitive than a rates move (see [SMS - Burning down the House](#), [Rates Alert - US and Europe: Lowering yield forecasts](#)).

The USD could fall sharply on a clearly dovish stance, but the drop is more likely to be sustained in EM than DM. The EM response among high yielders would probably be the most positive and the JPY could sustain gains, but the developed market (DM) FX response would probably be limited by the likelihood that other central banks would move in tandem with the Fed.

A hawkish surprise that put easing in question (or made it look as if the Fed were looking at 'one-and-done') would have major impacts across markets, in our view. Were Powell to put July easing in question, the market reaction could be so severe that dovishness elsewhere would not matter. Fixed-income investors are still long duration and equity investors would face an additional headwind. The USD would likely strengthen in both EM and DM, as the adjustment in US rates would likely be far more acute than abroad. DM currencies would face both risk-off and rates pressures.

We think such hawkishness is unlikely and expect 25bps cuts in July and Q4 (see [Economic Alert – Fed pre-emptive July cut](#)). The Fed has had prior opportunity to challenge market pricing. Investors also may be underestimating the importance of low inflation as it relates to the risks of hitting the zero bound and Fed easing. Monetary stimulus is much harder if the lower bound is hit. Below target and falling inflation means that the cost of being mistakenly tight is higher than the cost of easing that turns out not to be needed.

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To satisfy market pricing, Powell would need to repeat that the case for easing has strengthened and that the risks are to the downside. This would allay fears that the strong NFP data significantly affected the Fed's policy stance. Language like "the case for somewhat more accommodative policy has strengthened" or "incoming information on economic activity, on balance, has become somewhat more downbeat", or "Growth indicators from around the world have disappointed...the Committee...will act as appropriate to sustain the expansion" would be consistent with current market pricing. This does not put a timetable on easing, but combined with the lack of pushback on current market pricing, would point to an ease in July and sometime later in the year, as per our forecast.

Formally calling into question the Fed's prior optimism that inflation will pick up would be very dovish in our view. Similarly dovish would be a comment that uncertainty from trade disputes is likely to last longer than expected. The Monetary Policy Report refers to "transitory" inflation only once in the text. The more Powell cites risks that inflation is persistently soft, the more dovish the market reaction. To stress growth uncertainties, he might point to the weakness in investment and foreign growth.

Hawkish would be anything that puts into question a second cut. Hints at "one-and-done" could be devastating to market pricing, even if Powell pointed to a July cut. There is some worry in the market in the aftermath of the strong NFP but moderate slowing in growth is indicated by both labour and other data. Similarly, anything that unwound July easing prospects, even if only to push the move into September would be very hawkish relative to market pricing, in our view.



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Document approved by
Geoff Kendrick
Global Head, Emerging Markets FX Research

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