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YOUR GLOBAL FOREIGN EXCHANGE SPECIALIST

Week Ahead

14th – 18th June 2021

A week of central bank decisions but the Fed will draw most of the focus

This week's price action largely resulted around the dollar and events in US fixed income as the DXY toyed with the 90.0 handle. While policy decisions from the Bank of Canada and the European Central Bank were released, markets tended to focus on inflation barometers in the US ahead of next week's FOMC meeting. There was a lot of hype for Thursday's US CPI release, and while the inflation print didn't disappoint at 5%, the market reaction was underwhelming. The S&P 500 hit a fresh all time high, the US 10-year dropped 10bps to 1.43%, and the dollar broadly weakened. Next week, the economic calendar is brimmed with central bank policy decisions.

Authors

Simon Harvey
Senior FX Market Analyst
+44 (0)203 650 6472
Simon.Harvey@monexcanada.com

Olivia Alvarez Mendez
FX Market Analyst
+34 91 198 84 47
Olivia.Alvarez@monexcanada.com

Ima Sammani
FX Market Analyst
+31 020 808 3644
Ima.Sammani@monexcanada.com

> The **Federal Reserve**, **Central Bank of the Republic of Turkey**, and the **Central Bank of Brazil** are likely to be the most exciting ones out of the agenda.

Over the weekend, events in the UK will focus on the government's decision to stick to its June 21st reopening plan as cases of the delta variant rise.

Calendar

Monday – 14/06

A busy central banking week starts on a slow footing next week. **At 08:00 BST, Turkey releases current account data for April,** with economists expecting the current account deficit to narrow from $3.33bn to $2.21bn as a weaker lira and slowing credit growth start to take their impact. Then at **13:00 BST, Bloomberg's Nanos Confidence indicator for Canada is released for the week ended in June 11th**. The confidence indicator has steadily risen from mid-February as vaccines progress. With provinces exiting lockdown slowly, consumer confidence is expected to remain elevated. Meanwhile, at an undisclosed time on Monday, the **UK government is expected to announce whether to end England's lockdown on June 21st** amid an environment of rising Covid cases. A delay in the reopening has been speculated on by health officials in the media and we argue that its impact will be largely sentiment based. At around **14:45 BST the ECB will release their first round of PEPP purchases data** since last week's policy meeting. While the data is unlikely to give the central bank's new stance on what "significantly higher" purchases means until next week's release, the data will still be eyed by market participants.

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Tuesday – 15/06

UK labour market data for April kick starts Tuesday's session at 07:00 BST with expectations of no change in the 3-month unemployment rate from 4.8%. There were signs that the labour market began to heal prior to the furlough scheme ending in September, but this is unlikely to be witnessed in the rolling quarterly unemployment rate until later in the recovery. The data may begin to feel the boost of the April reopening, however. The focus then crosses the pond as **US retail sales and PPI inflation data are released at 13:30 BST.** The data comes just prior to Wednesday's FOMC decision but is unlikely to change the Fed's overall policy stance. Headline retail sales are expected to contract in May due to higher auto and gas prices, but the core reading is anticipated to grow by 1% MoM. Meanwhile, the Producer Price Index is anticipated to follow this week's CPI release and slow its monthly increase from 0.6% MoM to 0.4%. However, due to base effects, the year-on-year figure will remain elevated and is expected to hold at 6.2%.

Wednesday – 16/06

Inflation remains top of mind for markets on Wednesday as **May's CPI data from the UK is released at 07:00 BST.** The inflation data comes at a time when most policymakers reiterate that the overshoot will be transitory, with UK CPI expected to rise from 1.5% to 1.8% while the MoM data is expected to slow from 0.6% to 0.3%. Any upwards surprise will likely embolden claims from hawks like Andy Haldane, who this week wrote an op-ed on the dangers of not reacting significantly enough to rising inflation. Before turning to Canada's inflation data, markets will digest **China's retail sales report for May at 08:00 BST** where YoY growth is expected to slow from 17.7% to 14% due to base effects. On a month-on-month basis, however, a print of 14% would highlight increasing momentum in consumption, with a five-day holiday in early May likely leading to the increase in spending.

At 13:30, inflation will come back into scope with Canada's CPI data for May expected to show inflation partially rising from April's 3.4% reading. Deputy Governor Lane stated this week that inflation is expected to remain around 3% for some months before moderating, but the higher prints won't stoke a reaction from the central bank as they, like the Fed, view the overshoot as transitory. Sticking in North America, **the Federal Reserve will then release their latest policy decision at 19:00 BST with Governor Powell holding a press conference at 19:30 BST.** We discuss the implications of the Fed meeting in more depth below. To round off the day, markets will watch the latest **BCB decision at 22:30 BST** with the Brazilian central bank expected to hike rates by another 75 basis points. Having already started an aggressive normalisation cycle amid fast-growing inflation, question remain over how far the front-loaded the hiking cycle will go. While there's still ample room for rates to land in neutral territory, the Brazilian real is poised to welcome the improvement in carry trade conditions. However, spiralling inflation concerns in addition to long-lasting fiscal risks might force the BCB into excessive tightening, which might not fare well for the currency as higher rates weigh on economic conditions.

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Thursday – 17/06

Data at 02:30 BST is likely to show Australia's labour market stalling with 30,000 jobs expected to be added in May, almost a complete reversal of April's job losses. However, the signs of Victoria's two-week lockdown may be visible in the employment data in May and June. **At 08:30 markets will then hear the latest policy decision from the Swiss National Bank**, which is unlikely to be an exciting event, before the **Norges Bank releases their latest decision at 09:00 BST.** The Norges Bank has said they will look for clear signs of the normalisation of economic conditions before raising the interest rate path. Unemployment in May came in at 3.1%, while the Norges Bank expected 3.4% at the end of June, meaning unemployment has fallen quicker than the central bank had foreseen. Additionally, the regional network survey came in strong and showed that Norwegian businesses throughout all sectors expect higher activity and employment ahead. Beyond these factors, oil prices are higher than the NB expected, which should aid their oil-exporting economy further. These may be signs that will lead to the Norges Bank sending markets a clear signal for a rate hike in September vs the current expectation of a December rate hike, further supporting the Norwegian krone.

> "**The CBRT is expected to hold rates similar to the Norges Bank at 12:00 BST**, but the two banks are set on different courses."

Unlike the NB, the next policy decision from the CBRT is an expected interest rate cut, which President Erdogan has flagged for either July or August. Markets will analyse the policy statement on Thursday in order to determine what is the more likely meeting for a rate cut.

Friday – 18/06

After a week of UK data that is generally going to have limited market impact, **UK retail sales data for May is released at 07:00 BST.** Markets will be watching how this data prints with a very keen eye after the BoE CHAPS data showed aggregate credit and debit card spending on retail items cool in May as consumers showed some signs of fatigue. If consumer spending doesn't live up to the 2% MoM expectation, sterling will likely find itself under increased pressure, especially if the government highlights the health situation as more severe than expected when announcing their decision on the next phase of reopening earlier in the week. **The Bank of Japan meets next Friday, 18th,** although no specific time schedule has been set yet. The meeting is unlikely to catch much attention as no changes to the policy path are on the table. However, the event will be a useful platform to assess the evolution of the Japanese economy, which is on track to record a second contraction in Q2 amid a surge in Covid infections and further containment measures. Marginal support tools remain in discussion, although investors keep trading on the conviction that there is little else left to do by the BoJ to prevent deflationary dynamics.

FOMC preview

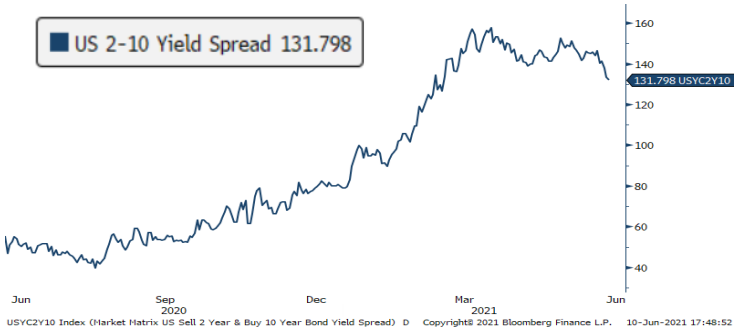
Federal Reserve to stand ground on surging inflation and push the QE taper signal to Q3

Since the last FOMC meeting, numerous overshoots in inflation data and signs of supply constraints in the labour market were paired with Federal Reserve policy makers shifting their tone to take on a slightly more hawkish stance. Over recent weeks, Presidents Bullard, Daly, Harker, Kaplan, Mester, Vice Chair Clarida and Governor Quarles stating that the FOMC should soon consider discussing tapering asset purchases. Daly described this as "talking about talking about tapering", which shouldn't be mistaken for a shift in policy of any sort. Despite this minor shift in tone, Fed officials have still continued to cast a dovish message over the last few months despite the firming of the economic data and reiterated the transitory characteristics of the inflation overshoots. Recent price action in FX and Fixed Income markets highlight participants are gaining confidence that inflation will be transitory. For all CPI and PCE releases over the last three months, the US dollar failed to hold onto gains despite the inflation overshoots and continued to trade on broader trends. Governor Brainard discussed in a speech that a steady approach to policy is the way to go in order to achieve the Fed's maximum employment and average inflation goals. "The Fed should remain steady in its approach during the transitory reopening surge", which suggests the central bank will continue to hold their cards close to their chest in the June meeting. If the ECB's outcome from June is anything to go by, the Fed will maintain its stance on policy for now while acknowledging the improving data is subject to noise.

Markets are finally buying into the Fed's stance on inflation

While some members, including Kaplan, have called for the Fed to begin discussing QE tapering at upcoming meetings, US policymakers seem unconcerned by rising inflation data on the whole. This stance by the Fed has helped anchor expectations of the Effective Fed Funds rate across the US Treasury curve as measured by Treasury Inflation-Protected Securities (TIPS or real rates). Therefore, much of the movement in nominal US yields has been driven by inflation expectations. Since March's meeting, nominal yields on the 10-year treasury have largely traded above 1.55% and below March's peak of 1.77%. Recently, however, they have fallen to as low as 1.43% despite the persistence of high inflation data.

The US Treasury curve has bull flattened over the past few weeks despite anecdotal and hard evidence of elevated inflation



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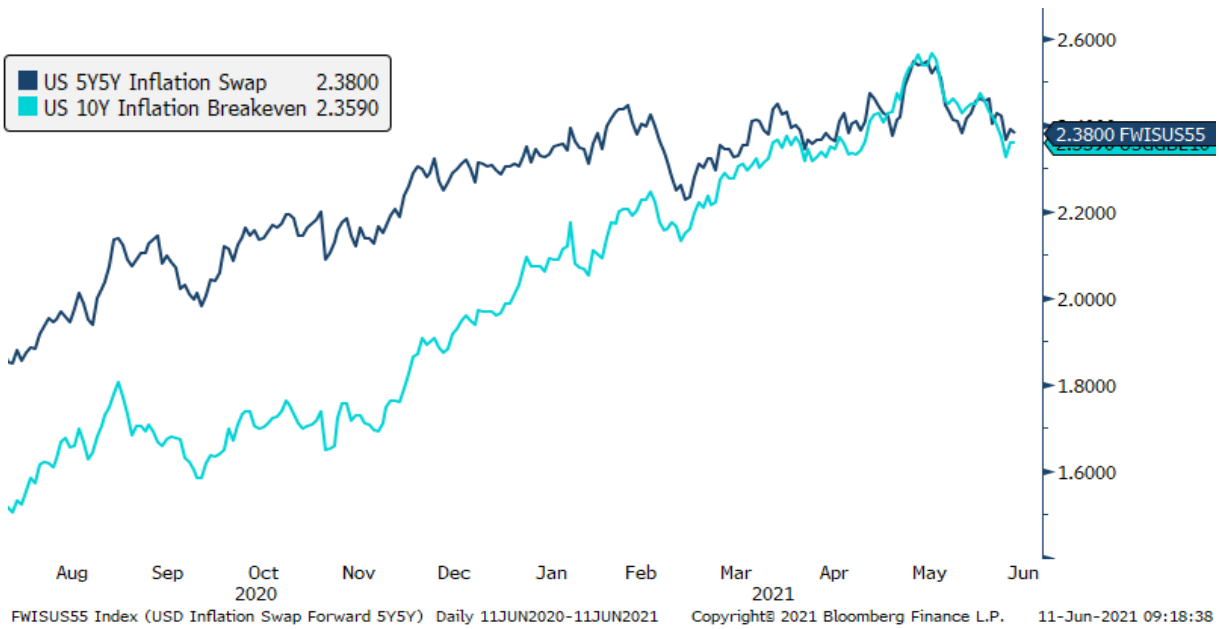
It takes more than a few data points to really define a trend and May's inflation data had arguments for both sides…

On the one hand, inflation was driven by base effects, elevated commodity prices and virus-sensitive industries bringing prices back up to pre-pandemic levels, all of which are expected to dissipate in the coming months. On the other hand, monthly inflation data showed price growth has momentum, while housing rent, which is a much stickier inflation component, is starting to trend upwards. But the collapse in inflation expectations, as viewed by 5y5y inflation swaps and 10-year inflation breakevens below, suggests to us that markets are going to sit the next few months out and believe the Fed when they say the near-term rise in inflation is transitory. Meanwhile, lackluster employment gains should be viewed through the price action in real yields, as higher inflation alone won't prompt the fed into a faster and more aggressive hiking cycle unless the recovery in the labour market is apparent.

> The question is, how long will the market be content with holding this view, how quickly does the period of elevated inflation have to pass, and will the Fed's announcement of QE tapering in Q3 be enough?



Surge in economic data set to continue over the summer

Although the Fed has been clear it will look through any transitory overshoots, June and July will likely continue to see elevated data as during this period last year, lockdown measures over many states were tightened while this summer the economy continues to reopen.

In the labour market, nonfarm payrolls have printed in a mixed fashion over the last months, although this was mostly due to the numbers being seasonally adjusted: raw numbers still saw significant increases in payrolls, with the services sector is picking up pace again. This is a good sign for labour market recovery. As the economy reopened, the question was whether this gap in the labour market caused by the pandemic would lead to more structural scarring or whether it would be gradually narrowed as lockdown measures were scaled back. The services sector posting large employment gains takes away at least some of the concerns around the structural scarring, while upside risks to wage growth have now increased as markets try to gauge how fast labour supply will react to meet the increase in labor demand. This is the hot question among economists at present as supply is still constrained by the weekly $300 unemployment benefits, which can work as a disincentive while Covid fears may also be weighing on supply. However, as the unemployment insurance top-up is removed over the coming months in some states, the continued dislocation in the labour market may show other factors in play. At this point, it is difficult to gauge whether the labour supply curve will shift enough to subdue the recent rise in wage growth and thus inflation concerns.

Fed officials to talk about QE tapering at a low level, while dot plot is key for forward guidance

As inflation rises amid positive signs in economic activity, markets have wondered whether a favourable macro reassessment by the Fed will lead to a change in the forward guidance. Asset purchases, the Fed's marginal policy tool at present, is in focus while interest rate expectations remain well anchored. Over the past months, tapering discussions have become increasingly relevant for markets in the view of evaluating the sensibility of the Fed's reaction function to incoming inflation data and pricing in a potential lift-off of back-end yields. However, a wide array of commentary from both sides of the Fed spectrum suggests that tapering discussions are just starting to appear. With a firm dual mandate on inflation and employment goals, the US economy is still far off the further progress needed to consider an effective withdrawal of stimulus.

"As inflation is mainly driven by temporary effects and a major unemployment gap is yet to be filled, the tapering of asset purchases shouldn't be put in place for the time being."

Consensus is growing around the idea that the Fed will start conducting smaller purchases from the beginning of next year, when the US economy is in a healthier position. Despite expectations of actual tapering in 2022, the announcement of such a timeline is expected around August, when the Fed might star in the Jackson Hole conference with the news. As the Fed´s policy path is outcome-based, relying on this agenda is merely indicative. A few more positive prints in labour market data will be necessary to that end.

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Recent Fed commentary on the tapering debate broadly overlooks temporary inflation surge

V - Voting member
AV - Alternate voting member
NV - Non-voting member

DOVISH

Kashkari

"I don't see any reason to [taper] right now."

Bullard

"I don't think we should do it when we're still in the pandemic. We're not quite there yet."

Evans

"I have not seen anything yet to persuade me to change my full support of our accommodative stance for monetary policy or our forward guidance about the path for policy."

Waller

"The takeaway is that we need to see several more months of data before we get a clear picture of whether we have made substantial progress towards our dual-mandate goals."

Brainard

"It is also important to be attentive to the risks of pulling back too soon."

Clarida

"We will certainly give advance warning before we anticipate scaling back the pace of those purchases. [Tapering will have] more of a focus on the labor market."

Powell

"The economy is reopening, bringing stronger economic activity and job creation. We are not out of the woods yet. We view maximum employment as a broad and inclusive goal."

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NEUTRAL

Harker

"We're planning to keep the federal-funds rate low for long, but it may be time to at least think about thinking about tapering our $120 billion in monthly Treasury bond and mortgage-backed securities purchases."

Daly

"We're talking about talking about tapering. Right now, policy is in a very good place. But it's too early to say that the job is done."

Bostic

"If we see substantial progress toward our goals, I'm going to be advocating moving policy. We are not there right now."

Barkin

"We have an outcome-based policy; when the outcomes look like substantial forward progress, that's the time to talk about [tapering]."

Williams

"We're still quite a way off from maintaining the substantial further progress that we're really looking for in terms of adjustments to our asset purchase program."

Bowman

"We really can't know how the pandemic will proceed and how that will affect the U.S. economy, but I think we are currently on a good path, and our policy is in a good place."

Quarles

"Trise in inflation - even after discounting temporary factors - and inflation expectations since December will prove sufficient to satisfy the standard for inflation in the guidance around asset purchases later this year."

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HAWKISH

Kaplan

"I think it would be wise sooner rather than later to begin gently taking our foot off the accelerator, so we can avoid and reduce the probability of having to apply the brakes down the road."

George

"As the pace and strength of the recovery unfolds, monetary policy settings remain highly accommodative and will remain so for some time in line with the FOMC's forward guidance."

Mester

"I wouldn't consider the increase in inflation I expect this year to be the type of sustainable increase needed to meet the forward guidance on our policy rate."

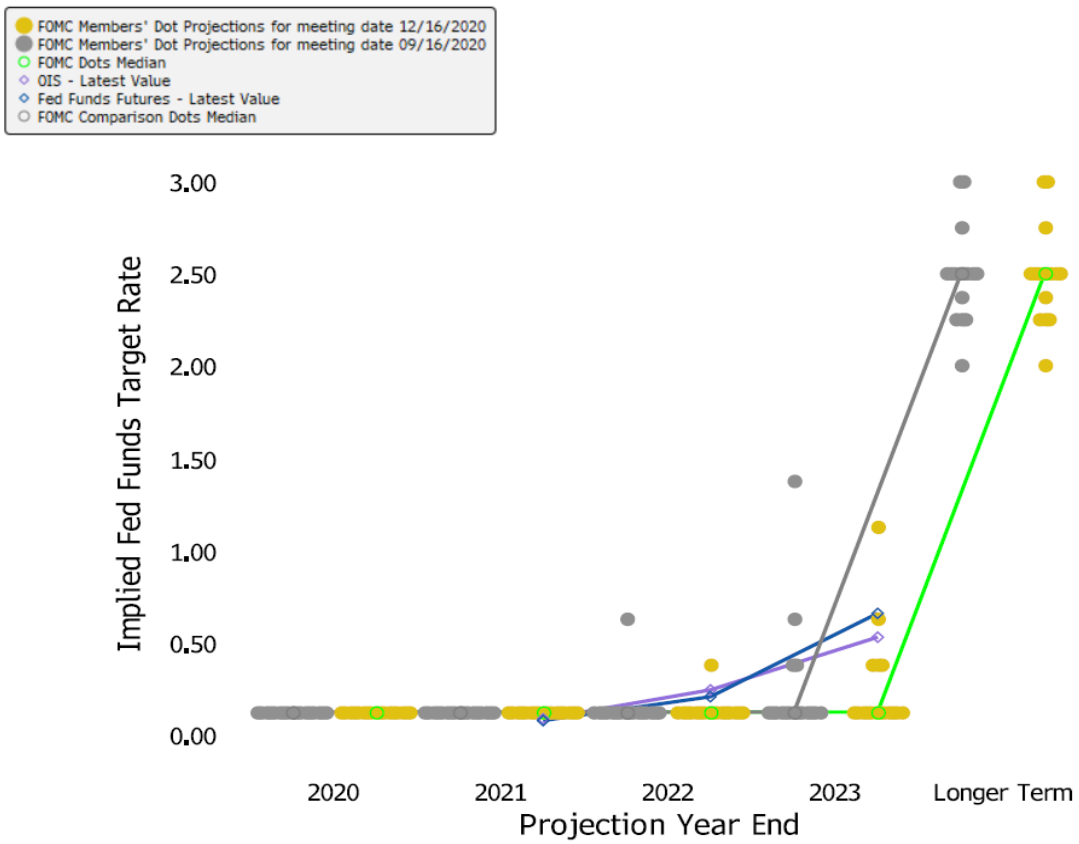
Rosengren

"We need to have a substantial improvement for us to begin tapering. […] It's quite possible that we'll see those conditions as we get to the latter half of the year …I think it's premature right now to focus on the tapering."

While tapering talks take the attention in the short term, expectations of interest rate adjustments rely on a broader assessment of the economic outlook and the Fed's forward guidance. The latest set of projections by Fed members indicated that consensus was built around hiking rates after 2023, although dissenters to this view were in crescendo. The March dot plot showed at least three voters leaned towards one 25pb hike in 2021, from none before; and only 11 were open to flat rates in 2022 from 16 previously. For 2023, at least two members foresaw a 1pp rate hike in the March projections, from just one voter in the December meeting. A similar readjustment in the votes could take place next week, which would lift the median expectation to show rate hike in 2023. However, we don't expect the median projection to signal an earlier lift-off in rates at this point, as this would show the Fed as less tolerable to inflation as recently suggested, but perhaps a few more members are now more optimistic on the economic outlook.

An adjustment in the dot plot might add some tailwinds to the US dollar, which has largely priced in the loose Fed stance already. At a two-year low, we argue that risks to the US dollar outlook are asymmetric, with upside surprises in the Fed communication likely to exceed downside pressures.

Improving DOT plot likely to curtail dollar declines



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