

A Potential IOER Tweak Headlines Potential FOMC FX Drama

Greg Anderson, CFA, PhD - Global Head of FX Strategy

Summary

- The Fed's interest rate decision on Wednesday May 1 at 14:00 will not include an SOEP update but will have a press conference.
- The chance of a move in the target range is zilch.
- With the Fed Funds rate drifting higher, there is a slight chance that the FOMC could cut the IOER by 5bps. More likely is that the FOMC lays groundwork for doing so in June.
- There is probably enough IOER adjustment priced into the market that either a hawkish or dovish surprise on this issue will move FX markets a bit. With the market still very short EURUSD, those risks are somewhat asymmetric.

Decision Communication Details

- The Statement will be released at 14:00 EDT (18:00 London time). The press conference will follow a half hour later at 14:30 EDT.
- As explained in this [Bloomberg editorial by Bill Dudley](#), any decision on the IOER belongs to the Fed's BOG and not the full FOMC. BOG decisions are announced in the Implementation Note that accompanies the Statement, not in the Statement itself. There is therefore an argument for Fed watcher to read that document before the Statement.

The IOER Issue

- The Fed's target range for the Fed Funds rate is 2.25% to 2.50%. That rate is set by private banks and other money market participants; the fed has no direct control over it. However, the Fed lends to banks at the IOER rate, so that is its instrument for influencing the Fed Funds rate.
- As detailed more fully in [BMO's Short Rates Weekly](#), the Fed Funds rate has been surprisingly drifting upward within the Fed's target range and is presently at about 2.45%. With IOER at 2.40%, there is now a noteworthy premium of Fed Funds over IOER.
- When this happened last year, the Fed twice responded (in June and December) by only hiking the IOER by 20bps while hiking the Fed Funds range by 25bps. In this way, the Fed (technically the BOG) signalled it wanted the Fed Funds rate to drift back down toward the middle of the target range.
- If the Fed were to cut the IOER by 5bps to 2.35%, it would send a loud signal to markets and would presumably pull the Fed Funds rate back towards the middle of the target range. However, such a rate cut would presumably also get the curve to price in actual target range cuts much more aggressively than it now does.
- With the money market curve pricing in 2-3bps of cuts in the Fed Funds rate tomorrow, it appears that the market is pricing in a reasonable probability of an IOER move at this meeting. We think tomorrow is too soon for a 5bp IOER cut, but we do think the Fed could begin to lay the groundwork for doing so in June via the Statement and Press Conference.

Statement Considerations

- The economic conditions paragraph of the [March 20 Statement](#) will need substantial updating. The preponderance of the data flow since that meeting has been more positive than it was in the last interlude between meetings and the Statement will need to reflect that. In particular, the discussion of GDP growth and employment will need to take on a sunnier tone.
- The obvious way to offset a more positive tone on growth is to take a more cautious tone on inflation and the data supports that. In March the FOMC said that "overall inflation has decline, largely as a result of lower energy prices."

With Q1 core PCE coming in at 1.3% annualized QoQ and March core PCE coming in at 1.7% YoY, lowflation looks more pervasive now than it did in March. We think the FOMC is likely to note that point somewhat loudly.

- We don't think there will be any type of bias inserted. There is no reason for any discussion of the USD; we think the language regarding watching "readings on financial and international developments" will remain unaltered.
- If there was any chance of anyone breaking from this year's unanimity by voting for a rate cut, today's call by President Trump for the Fed to cut by 100bps and resume bond purchased probably quashed that. Any break from unanimity would be a substantial shock.

Presser Points

- We expect Powell's twin talking points to be "the economy is great" and "inflation is surprisingly low." That would mirror the Statement and provide Powell with ammunition for the extended pause that the whole G20 central banking community seems to have arrived at.
- We expect Powell to duck out of any questions about the USD. EURUSD is about 2% lower now than it was in the wake of the March 20 FOMC, but we think Powell would decline discussion of that point. After a period of raucous comments on the USD coming from all directions in 2017 and H1 of 2018, the Trump Administration seems to have settled into an equilibrium of not commenting on USD levels. We don't think Powell would want to do anything to risk Administration quietness on FX by making comments that could re-start the dialogue.

The Scenario Spectrum

- Although this FOMC should not be a major market mover, the IOER issue does provide a bit of potential for minor drama on this technical detail. We therefore use it as our primary instrument for defining a dovish or hawkish outcome.
- As outlined in Figure 1, we think a neutral FOMC would be one where the Fed lays a bit of groundwork in order to be able to cut the IOER in June, but doesn't commit to do so.
- A dovish outcome would be one where the Fed cuts the IOER today or almost commits to do so in June.
- A hawkish outcome would be one where the upward drift in the Fed Funds rate is underplayed along with the softness in core inflation data thus far in 2019.
- For our wildcard scenario, we throw out the possibility of one voter favouring a cut. We give that just a 2% probability.
- Given the still heavy short-EURUSD positioning, we have that pair with an asymmetric response to the dovish and hawkish scenarios. A bounce higher in EURUSD is the market's clear pain trade right now.

Figure 1: FOMC Scenario and FX Response Table

Scenario Description	FX Market Mood Response	Probability	Resulting Exchange rates			
			USDCAD	EURUSD	USDJPY	USDMXN
Strong data emphasized, no mention of Fed Funds updrift, lowflation underplayed	Add to USD longs, the Fed's back to hawkish!	15%	1.3480	1.1150	110.80	19.20
Strong data and lowflation presented as offsets, groundwork laid for 5bp IOER cut later	Back to our boredom :(70%	1.3390	1.1190	111.40	19.00
IOER cut by 5bps or a near promise is made to do so	It's probably best to reduce USD longs a tad	13%	1.3290	1.1350	112.00	18.80
1 voter dissents in favor of a rate cut at this meeting	Dump USD longs now; the Fed's gunna cut!	2%	1.3250	1.1390	112.50	18.70
		baseline	1.3390	1.1210	111.40	19.00

Sources: BMO CM, Bloomberg

Institutional Investor's Global Fixed-Income Research Team survey is open.

Please vote for us!

(FX is under the USA Economics & Strategy category)

Request a ballot

FICC Macro Strategy

FX Central Bank Alert

CONTACTS

Margaret Kerins, CFA MD Head of FI Strategy
margaret.kerins@bmo.com 312-845-2687

Greg Anderson, CFA Director Head Global FX Strategy
gregory.anderson@bmo.com 212-605-1409

Dan Krieter CFA Director Fixed Income Strategy
dan.krieter@bmo.com 312-845-4015

Jon Hill, CFA Vice President Fixed Income Strategy
jonathan.hill@bmo.com 212-702-1270

Ben Jeffery Analyst Fixed Income Strategy
benjamin.jeffery@bmo.com 212-885-4135

Ian Lyngen, CFA MD Head of US Rates Strategy
ian.lyngen@bmo.com 212-702-1703

Stephen Gallo Director Head European FX
Strategystephen.gallo@bmo.com 44-2076648124

Benjamin Reitzes Director Canadian Rates & Macro Strategist
Benjamin.Reitzes@bmo.com 416-359-5628

Dan Belton, PhD Vice President Fixed Income Strategy
daniel.belton@bmo.com 312-845-5068

DISCLOSURE

This material has been prepared with the assistance of employees of Bank of Montreal, BMO Nesbitt Burns Inc. and BMO Capital Markets Corp. (together, "BMO") who are involved in fixed income and foreign exchange sales and marketing efforts. Accordingly, it should be considered to be a solicitation of the fixed income and foreign exchange businesses generally and not a research report that reflects the views of disinterested research analysts.

Notwithstanding the foregoing, this material should not be construed as an offer or the solicitation of an offer to sell or to buy or subscribe for any particular product or services (including, without limitation, any commodities, securities or other financial instruments).

We are not soliciting any specific action based on this material. It is for the general information of our clients. It does not constitute a recommendation or a suggestion that any investment or strategy referenced herein may be suitable for you. It does not take into account the particular investment objectives, financial conditions, or needs of individual clients.

Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your unique circumstances, or otherwise constitutes an opinion or a recommendation to you. BMO is not providing advice regarding the value or advisability of trading in commodity interests, including futures contracts and commodity options or any other activity which would cause BMO or any of its affiliates to be considered a commodity trading advisor under the U.S. Commodity Exchange Act. BMO is not undertaking to act as a swap advisor to you or in your best interests and you, to the extent applicable, will rely solely on advice from your qualified independent representative in making hedging or trading decisions. This material is not to be relied upon in substitution for the exercise of independent judgment. Any recipient of these materials should conduct its own independent analysis of the matters referred to herein, together with its qualified independent representative, if applicable. Any discussion of tax matters in these materials (i) is not intended to be used, and cannot be used or relied upon, for the purposes of avoiding any tax penalties and (ii) may have been written in connection with the "promotion or marketing" of the transaction or matter described herein. Accordingly, the recipient should seek advice based on its particular circumstances from its own independent financial, tax, legal, accounting and other professional advisors (including, without limitation, its qualified independent representative, if applicable).

These materials are confidential and proprietary to, and may not be reproduced, disseminated or referred to, in whole or in part without the prior consent of BMO. Information presented in this material has been obtained or derived from sources believed by BMO to be reliable, but BMO does not guarantee their accuracy or completeness. BMO assumes no responsibility for verification of the information in these materials, no representation or warranty is made as to the accuracy or completeness of such information and BMO accepts no liability whatsoever for any loss arising from any use of, or reliance on, these materials. BMO assumes no obligation to correct or update these materials. These materials do not contain all information that may be required to evaluate any transaction or matter and information may be available to BMO and/or its affiliates that is not reflected herein.

These materials do not contain all information that may be required to evaluate any transaction or matter and information may be available to BMO and/or its affiliates that is not reflected herein.

BMO and its affiliates may have positions (long or short), and effect transactions or make markets, in securities mentioned herein, or provide advice or loans to, or participate in the underwriting or restructuring of the obligations of, issuers and companies mentioned herein. Moreover, BMO's trading desks may have acted on the basis of the information in these materials.

BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A. (member FDIC), Bank of Montreal Ireland p.l.c, and Bank of Montreal (China) Co. Ltd and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Investment Industry Regulatory Organization of Canada and Member Canadian Investor Protection Fund) in Canada and Asia and BMO Capital Markets Limited (authorised and regulated by the Financial Conduct Authority) in Europe and Australia.

® Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ - "BMO (M-bar roundel symbol) Capital Markets" is a trade-mark of Bank of Montreal, used under licence.

TO U.K./E.U. RESIDENTS: In the UK, Bank of Montreal London Branch is authorised and regulated by the Prudential Regulation Authority and the Financial Conduct Authority ("FCA") and BMO Capital Markets Limited is authorised and regulated by the FCA. The contents hereof are intended solely for clients which satisfy the criteria for classification as either a "professional client" or an "eligible counterparty", each as defined in Directive 2014/65/EU. Any U.K. person wishing to effect transactions in any security discussed herein should do so through Bank of Montreal, London Branch or BMO Capital Markets Limited; any person in the E.U. wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Limited.

TO PRC RESIDENTS: This material does not constitute an offer to sell or the solicitation of an offer to buy any financial products in the People's Republic of China (excluding Hong Kong, Macau and Taiwan, the "PRC"). BMO and its affiliates do not represent that this material may be lawfully distributed, or that any financial products may be lawfully offered, in compliance with any applicable registration or other requirements in the PRC, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. This material may not be distributed or published in the PRC, except under circumstances that will result in compliance with any applicable laws and regulations.

TO HONG KONG RESIDENTS: This material has not been reviewed or approved by any regulatory authority in Hong Kong. Accordingly the material must not be issued, circulated or distributed in Hong Kong other than (1) except for "structured products" as defined in the Securities and Futures Ordinance, in circumstances which do not constitute it as a "Prospectus" as defined in the Companies Ordinance or which do not constitute an offer to the public within the meaning of that Ordinance, or (2) to professional investors as defined in the Securities and Futures Ordinance and the Securities and Futures (Professional Investor) Rules made thereunder. Unless permitted by the securities laws of Hong Kong, no person may issue in Hong Kong, or have in its possession for issue in Hong Kong this material or any other advertisement, invitation or document relating to the products other than to a professional investor as defined the Securities and Futures Ordinance and the Securities and Futures (Professional Investor) Rules.

TO SINGAPORE RESIDENTS: This document has not been registered as a prospectus with the Monetary Authority of Singapore and the material does not constitute an offer or sale, solicitation or invitation for subscription or purchase of any shares or financial products in Singapore. Accordingly, BMO and its affiliates do not represent that this document and any other materials produced in connection therewith may lawfully be circulated or distributed, whether directly or indirectly, to persons in Singapore. This document and the material do not and are not intended to constitute the provision of financial advisory services, whether directly or indirectly, to persons in Singapore.

TO THAI RESIDENTS: The contents hereof are intended solely for the use of persons qualified as Institutional Investors according to Notification of the Securities and Exchange Commission No. GorKor. 11/2547 Re: Characteristics of Advice which are not deemed as Conducting Derivatives Advisory Services dated 23 January 2004 (as amended). BMO and its affiliates do not represent that the material may be lawfully distributed, or that any financial products may be lawfully offered, in compliance with any regulatory requirements in Thailand, or pursuant to an exemption available under any applicable laws and regulations.

TO KOREAN RESIDENTS: This material is not provided to make a recommendation for specific Korean residents to enter into a contract for trading financial investment instruments, for investment advising, for discretionary investment, or for a trust, nor does it constitute advertisement of any financial business or financial investment instruments towards Korean residents. The material is not provided as advice on the value of financial investment instruments or any investment decision for specific Korean residents. The provision of the material does not constitute engaging in the foreign exchange business or foreign exchange brokerage business regulated under the Foreign Exchange Transactions Act of Korea.

In Asia, Bank of Montreal is licensed to conduct banking and financial services in Hong Kong and Singapore. Certain products and services referred to in this document are designed specifically for certain categories of investors in a number of different countries and regions. Such products and services would only be offered to these investors in those countries and regions in accordance with applicable laws and regulations. The Information is directed only at persons in jurisdictions where access to and use of such information is lawful.