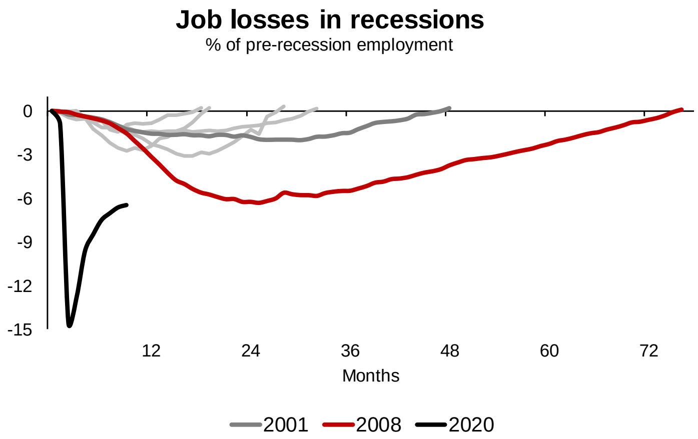
GIAM Macro & Market Research- Market Commentary

A relatively bullish Fed prefers forward guidance to changes in asset purchases

- **The Fed revised up its growth and labour market projections but stated again that the path to full employment and inflation at target is a long and uncertain one.**
- **However, and despite the concerns about the economy in the next months, it refrained from altering the size, pace and composition of asset purchases. Instead it strengthened guidance linking the developments of QE on the attainment of full employment and inflation averaging 2%.**
- **Powell stressed again that it is up to fiscal policy to provide a bridge until the vaccine rollout will boost growth in the second half on next year. QE will be stepped up should risks to the medium term outlook materialise.**

The Fed decided to act on words rather than on deeds as the tools at its disposal are not useful to sustain the economy in the short run. Yet guidance on QE was provided: the pace of asset purchases will remain at least stable until full employment is reached again, and inflation shows more signs of life, i.e. it has reached 2% and is set to increase further. That was the only relevant change with respect to the November statement. Yet no definition of full employment was provided, nor any indication of hard intermediate goals the Fed will use to assess the progress toward the target.
The other big news was the upgrade of the growth and unemployment forecast, despite the weakening of some indicators published since the November, especially as far as the labour market is concerned (see chart below and table at the end of the piece).



FOMC members expect the second wave to trigger a relatively mild slowdown around the turn of the year and seem to put faith into a positive outcome of the ongoing discussion in the Congress around a US$ 900 bn package. On unemployment, the pre-crisis 3.7% level should be reached by 2023, according to the median projections, but individual forecasts range from 5% to 3.3%; chair Powell stressed the still low level of participation compared to before the pandemics and the fact that joblessness affects in particular low skilled persons and minorities.
What remains unchanged is the expectation of a flat Philips curve: the inflation forecast was upgraded minimally, with the core rate reaching 2% only in 2023, with the upper end of the projection range at just 2.2%. Over the coming months there can be temporary spikes in prices as pent up demand materializes, but the Fed will look though them. Under the new Average inflation targeting it is easy to infer that the policy rates will stay at near zero until after 2024. The global forces pushing

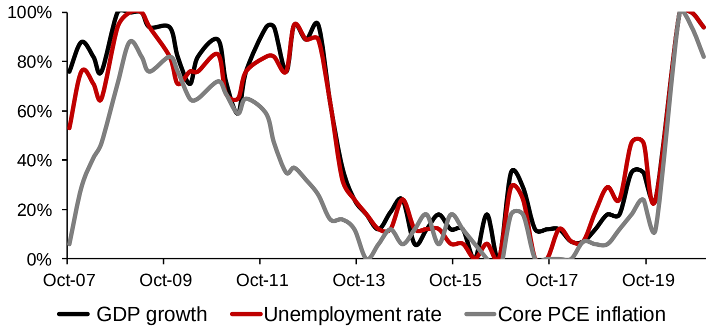
down inflation remain at play and bring it back to target will be as slow as it was after the Great Financial Crisis: on the positive side this could allow for another long recovery

Median projections					
	2020	**2021**	**2022**	**2023**	**Longer run**
Change in real GDP	-2.4	4.2	3.2	2.4	1.8
Sep. projections	*-3.7*	*4.0*	*3.0*		*1.9*
Unemployment rate	6.7	5.0	4.2	3.7	4.1
Sep. projections	*7.6*	*5.5*	*4.6*		*4.1*
PCE inflation	1.2	1.8	1.9	2.0	2.0
Sep. projections	*1.2*	*1.7*	*1.8*		*2.0*
Core PCE inflation	1.4	1.8	1.9	2.0	
Sep. projections	*1.5*	*1.7*	*1.8*	*2.0*	
	Appropriate policy path				
Federal funds rate	0.1	0.1	0.1	0.1	2.5
Sep. projections	*0.1*	*0.1*	*0.1*	*0.1*	*2.5*

An important addition to the material made available was a series of gauges of the uncertainty surrounding the projections, consistent with the repeated downplaying of importance the point forecasts which are an almost constant feature of Powell's post meeting remarks. The chart below shows that, while down from the peak of September, forecast uncertainty remains extremely high (and tightly related to the unprecedented experience of a massive vaccine rollout): another factor in favour of verbal guidance over direct action on asset purchases.

Uncertainty around the forecast

Net % of FOMC members stating that forecast uncertainty is higher than in the past



During the press conference the bulk of the question was about the choice of not to change QE given the concerns about the economy over the next six months (until herd immunity is reached). Powell resorted to the usual "monetary policy works with long and variable lags": stepping up Treasury purchases will not do much to prop up demand in the short term. Moreover, interest rate sensitive sectors like construction are almost booming. The rest of the economy is suffering from

health-related restrictions and lack of confidence due to the pandemics. To heal this problem fiscal policy, in the form of income support is much more effective. Yet the Fed is ready to use its tools should medium term growth prospects start to weaken.
Chair Powel also underlined that the current pace of QE is steering inflation expectations in the right direction as witnessed by the steady increase in long term breakevens. He does not believe that, at this stage, a bigger or different QE will help much a quicker reflation. Recourse to additional measures like credit purchases requires the approval by the Treasury, so their availability is probably a matter of few weeks.

Finally, the Fed is not concerned by the high equity valuation or the risk of a spike in house prices. Some issues related to financial stability (like corporate leverage) deserve attention but overall, there are not many red flags.

Variable	Previous FOMC meeting	Latest	Chg. Since Prev. Meeting
Real Activity			
GDP (% yoy)	-9.0	-2.9	6.1
Weekly activity index (scaled to yoy GDP)	-3.0	-2.3	0.6
ISM - Manuf	59.3	57.5	-1.8
ISM - Services	56.6	55.9	-0.7
Macro Surprises	123.2	77.5	-45.7
Labor Market			
Payroll growth (3 mth. MA)	938	522	-416
Unemp. Rate	6.9	6.7	-0.2
Unemp. Rate (broad)	12.1	12	-0.1
Hourly wages, % yoy (3 m. MA)	4.6	4.4	-0.2
Prices			
Core CPI	1.6	1.6	0.0
Core PCE	1.6	1.4	-0.2
Trimmed PCE	1.8	1.7	-0.1
U. Mich 5 yr exp.	2.5	2.5	0.0
NY Fed 3 Y exp.	2.7	2.8	0.1
5Y5Y fwd exp.	1.8	2.0	0.2
Financial Conditions			
Chicago Fed index*	-0.50	-0.62	-0.12
10 yr. Treasury	0.77	0.92	0.15
- Risk neutral Component	1.38	1.33	-0.05
- Term Premium	-0.62	-0.41	0.21
Yield curve (10Y - 2Y)	0.62	0.80	0.18
S&P 500	3443.4	3694.6	7.3%
Trade Wighted Dollar	121.8	118.4	-2.8%
WTI Crude Oil	39.0	47.6	22.2%
* Decrease: looser conditions			

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