MARKET COMMENTARY

Tapering begins, but it is not yet time for higher Fed funds rates

Author: Paolo Zanghieri

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- **As widely expected, the Fed will start reducing bond purchases before the end of the month. Net purchases will end in June.**
- **The well-advertised view that the current inflation is just a temporary phenomenon was, detailed in the press release, which also hinted at supply bottlenecks as the major cause of slow employment growth and volatile activity. The belief that the easing of constraints will lead to stronger employment growth and more moderate inflation was reiterated too.**
- **Chair Powell repeated that the much more demanding test for lift-off is not met as the labour market remains weak, partially pushing back against market expectations of an early rate hike in mid-2022. Importantly, the FOMC thinks that when full employment is reached (by Q3-2022 at the earliest) it is possible that inflation could be at a level consistent with a rate hike. We still point to Q4 2022 as the most likely time for the first rate hike.**

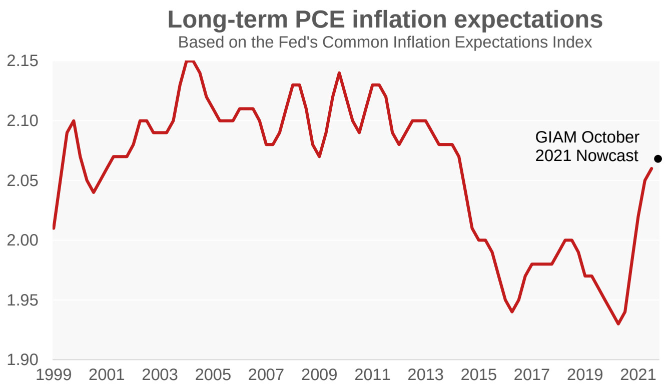
As widely expected, and effectively telegraphed by the Fed, tapering will begin in November, as the economy has made substantial further progress toward the goals the FOMC set. **The Fed will reduce bond purchases by US$ 15bn (US$ 10 in Treasuries and US$ 5 bn in MBS) per month starting from mid- November**, leading to zero net purchases by June. The reduction in asset purchases will be much faster than in the past as demand and the labour market are much stronger compared with the post Great Financial Crisis recovery.

The move was largely anticipated by markets, what was a bit more surprising was **the reiteration of the view that the spike in inflation is largely "expected to be transitory"** and caused by supply and demand imbalances related to the reopening of the economy. This deserved and added paragraph in the press release, as well as the explicit mention of supply bottlenecks and labour shortages as main factors behind slow employment growth and volatile activity data (see the comparison with September attached). But the Fed continues to believe that **the easing of these constrains and progress in vaccination will deliver strong employment and activity growth and contribute to moderating inflation**.

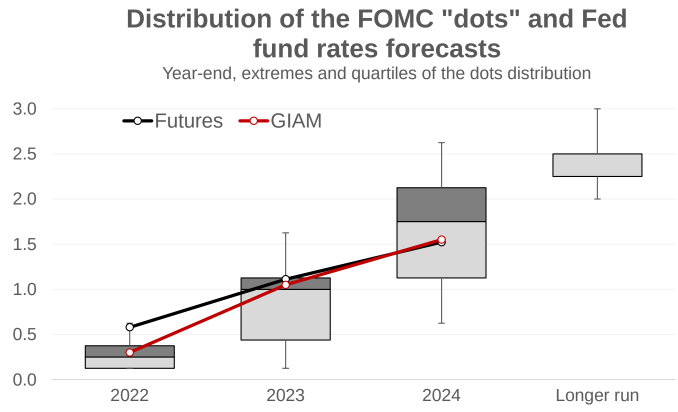
"Transitory", chair Powell took care to explain, is not much related to the duration of the disruptions, but rather to the fact that **they are not expected to leave behind permanent effects on inflation**. The FOMC recognises that supply bottlenecks are lasting more than expected and will affect the economy well into next year. Current inflation is clearly not consistent with price stability, he added, but is very atypical in its nature, as it not related to a tight labour market and is mostly driven by goods, which had had negative price growth for decades. The rebalancing in demand from goods to services will be critical in reducing bottlenecks and normalise inflation. He acknowledged the problems high inflation is creating and that central banks have limited tool to fight this kink of price pressures. **The baseline scenario remains that of a substantial moderation form late Q2 or in Q3 2022.**

The fast progress in employment seen in the first part of the year has been stopped by the Delta variant, and **the impact of the pandemic still clouds the outlook for the labour market**. Participation rate remains low and not just because of early retirement. Prime age people, chair Powell stressed, stay away from the labour market because of the fear of contagion and the impact on childcare. The FOMC then sticks to the view that a rapid recovery in participation will bring about healthy job gains in the coming months. But, **currently the labour market remains weak and it absolutely not the time to think about raising rates**, added, in part pushing back about market expectations of the fist rate hike occurring already in mid-2022, followed by another one before the end of the year. Patience is still needed, and the Fed remains focussed on the labour market employment. Chair Powell thinks that **full employment could be reached as early as in mid-2022**. The Fed will then assess whether the inflation objective has been met too; this is within the range of the possibilities. Patience is also warranted by the fact that the quick pace of wage increases is largely reflecting economic dislocation and has been so far matched by raising productivity. Therefore, **the risk of a wage price spiral is very limited**. Faster action remains possible if expectations start diverging more markedly from the target; for the time being the Fed gauge of long-term expectations seems to be increasing at a much moderate pace and is back to the 2013 level. Given our forecasts for next year, **we still think that a rate hike in Q4 is the most likely scenario**.

The call for patience was in part heard by markets: the yield on the 2-year Treasuries dropped from 0.98% to 0.96% after the press release, offsetting in part the rise from 0.92% that preceded the Fed's announcement.



Source:Federal Reserve Board, Datastream, GIAM calculations



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