Market Commentary

The Fed signals imminent tapering, expects to raise rates in 2022

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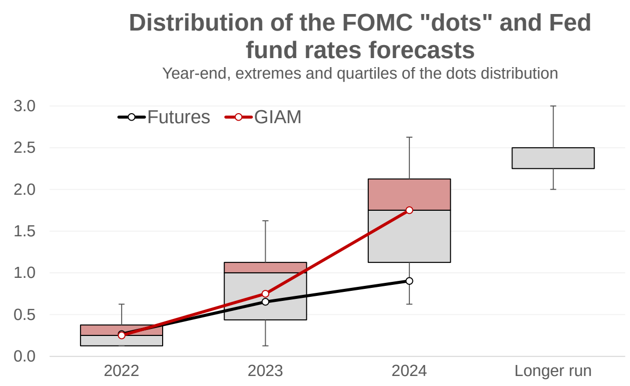
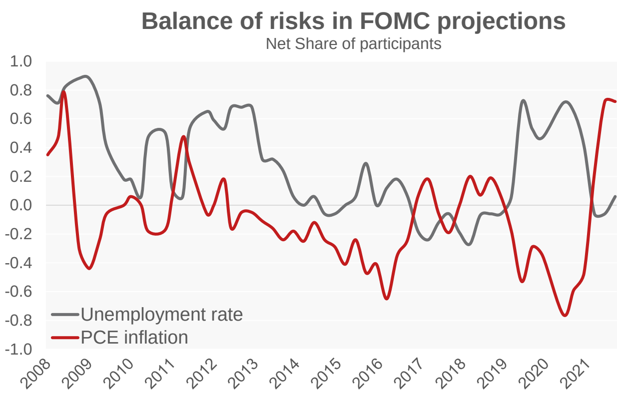
- Despite risks for growth due to bottlenecks, the Fed maintains an optimistic view on the US economy. Conditions are ripe for a reduction in asset purchases that could be announced as early as in the November meeting. Net asset purchases should then get to zero by mid-2022.
- The prospects of sustained employment gains and concerns about inflation expectations moved the “dots” for 2022 towards one rate hike, but the committee is evenly split on that decision. The policy rate is expected to climb to 1.75% by the end of 2024.
- Growth projections for 2021 were revised down and that for inflation sizeably up, to account for the impact of the supply chain disruptions, but the Fed reiterates its belief that the problems are temporary.

The Fed signaled a strong conviction to speed up normalization, explicitly indicating that the November meeting could stage the announcement of the beginning of tapering. Moreover the rate liftoff could already take place in 2022. The hawkish turn was motivated by a stronger belief that, despite some signs of deceleration (see table at the end), the underlying dynamics of the economy is strengthening and by the preoccupation that a longer lasting inflation overshooting ends up in raising expectations.



Source:Federal Reserve Board, Datastream,



Source:Federal Reserve Board

The press release contained small but significative changes. On the economy, the FOMC signaled that Risks related to COVID are receding in line with the slowdown of infection. But it also remined that inflation is “elevated”. On the policy front, a continuation of the current pace of labour market improvement would soon warrant a reduction in asset purchases.

The projections reflected the speed bump the economy is facing as supply bottlenecks hamper activity in several sectors. While 2021 growth was downgraded markedly, the longer-term growth outlook was revised slightly up. Job creation is projected to be a bit slower this year in comparison with the June projection, but the target of unemployment rate at 3.8% by the end of 2022 remains achievable. This is the level some Committee members have associated to full employment. Higher than expected realized inflation for this year translated into a sharp upward revision of the short-term outlook. The transitory character of the overshooting remains, but Powell admitted that higher inflation due to bottlenecks could drag into 2022.

	Median projections				
	2021	**2022**	**2023**	**2024**	**Longer run**
Change GDP	5.9	3.8	2.5	2.0	1.8
June projections	7.0	3.3	2.4		1.8
Unemp.rate	4.8	3.8	3.5	3.5	
June projections	4.5	3.8	3.5		4.0
PCE inflation	4.2	2.2	2.2	2.1	2.0
June projections	3.4	2.1	2.2		2.0
Core PCE inflation	3.7	2.3	2.2	2.1	
June projections	3.0	2.1	2.1		
	Appropriate Fed funds path				
Federal funds rate	0.1	0.3	1.0	1.8	1.5
June projections	*0.1*	*0.1*	*0.6*		*2.5*

In the press conference, Powell stated that the progress needed to begin tapering was already attained on inflation and is very close on employment. He reckoned that over 50% of the gap between actual and equilibrium unemployment has already being bridged. Moreover, the FOMC dismissed the weak August employment as the result of the residual drag on labour market participation caused by childcare and fears of contagion. Both factors should disappear quickly during the autumn, allowing employment to accelerate. Powell called “inexorable” the return to work of the people laid off due to the pandemic. As most FOMC members believe that the substantial further progress on employment is around the corner or has already been achieved, QE has lost most of its usefulness and some FOMC members have voiced concerns about financial stability. Therefore, Powell clearly stated that tapering should be announced already at the next meeting (Nov. 3). The bar for a delay is rather high: the FOMC looks at the cumulative labour market improvement and only a strong disappointment from the September employment report would lead the committee to pause. There is also a strong agreement on a quick pace of tapering. The FOMC thinks it should end by mid-year: this implies a reduction of purchases by roughly US$ 15bn per month. The discussion on how to shrink the balance sheet will begin only when tapering is underway.

The reshuffling of the dots for 2021 lead the median to move up signalling a rate hike already in 2022. Powell took care of stressing that the FOMC is evenly split on the issue: nine members predict a move by the end of next year and the remaining nine holding off until 2023. In June, seven officials saw a rate rise next year. They also project a faster pace of rate normalization, with three hikes in 2023 (against two in June) and in 2024. At the end of that year the policy rate will reach 1.75. We expect that level to be reached with a slightly different, more cautious, path: we now pencil in a rate hike towards the end of 2022, only two in 2023 and four in 2024.

The steepening of the fed funds path is meant to provide a strong signal of the commitment to rein in any possible upward slippage in expected inflation. Powell said several times during the Q&A session that long term expectations have risen back to the 2013 levels and have so far showed no signs of deanchoring.

Finally, Powell declined to comment on the Debt ceiling issue and played down the risks that the Evergrande troubles can create to the US economy. Direct exposure of the financial sector is limited. He also strongly denied any parallel with US corporate debt. Concerns about leverage were high hat the beginning of the pandemic, but the strong policy response has kept defaults low.

Variable	Previous FOMC meeting	Latest	Chg. Since Prev. Meeting
Real Activity			
Weekly activity index (scaled to yoy GDP)	11.9	7.8	-4.1
ISM - Manuf	60.6	59.9	-0.7
ISM - Services	60.1	61.7	1.6
Macro Surprises	43.3	-29.5	-72.8
Labor Market			
Payroll growth (3 mth. MA)	615	750	135
Unemp. Rate	5.9	5.2	-0.7
Unemp. Rate (broad)	9.8	8.8	-1.0
Hourly wages, % yoy (3 m. MA)	2.4	4.5	2.1
Prices			
Core CPI	3.8	4.0	0.2
Core PCE	3.5	3.6	0.1
Trimmed PCE	1.9	2.0	0.1
U. Mich 5 yr exp.	2.8	2.9	0.1
NY Fed 3 Y exp.	3.55	4.0	0.5
5Y5Y fwd exp.	2.3	2.1	-0.2
Financial Conditions			
Chicago Fed index*	-0.70	-0.69	0.01
10 yr. Treasury	1.62	1.32	-0.30
- Risk neutral Component	1.21	1.44	0.23
- Term Premium	0.41	-0.11	-0.52
Yield curve (10Y - 2Y)	1.45	1.11	-0.34
S&P 500	4183.2	4354.2	4.1%
Trade Wighted Dollar	118.5	120.4	1.6%
WTI Crude Oil	63.9	70.6	10.5%
* Decrease: looser conditions			