

## Fed doves no longer rule the roost

The Federal Reserve left monetary policy unchanged, but there is a subtle yet significant change in the language that hints we are on the path toward a tapering of the Fed's QE asset purchases later this year. With supply side issues clashing against stimulus fuelled demand we see inflation as a persistent issue with a growing prospect of a 2022 Fed rate hike



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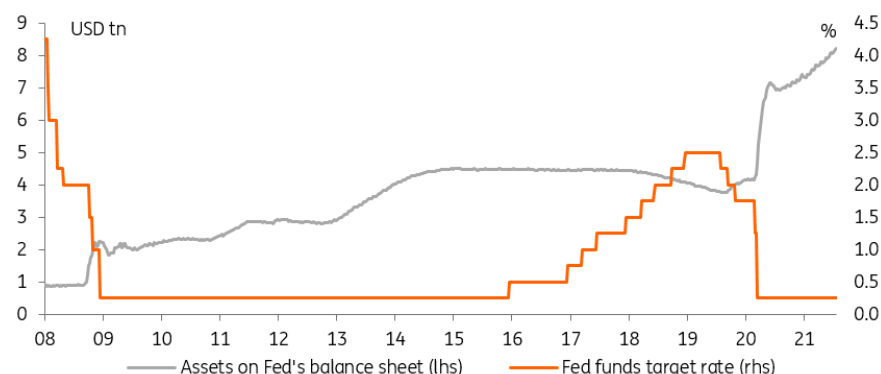
### Singing a new tune

Ahead of time, Fed Chair Jerome Powell made it clear that he continues to believe inflation pressures are largely transitory and there is no need to signal an imminent shift in policy. We got a repeat of the “transitory” assessment in today’s FOMC statement, but we have had clear movement that hints the Fed will in fact start to taper its QE asset purchases later this year.

The Fed funds target rate has been left at 0-0.25% with the monthly QE asset purchases left at a total of \$120bn split \$80bn Treasury securities and \$40bn agency MBS. Previously the statements had remarked that these purchases would continue until “substantial further progress has been made” towards achieving maximum employment and the Fed consistently hitting its inflation target. However, the Fed has seen enough in the data to indicate that “the economy has made

progress towards these goals”. This is a significant step in the policy normalisation process.

## Assets on the Fed's balance sheet vs. interest rates



Source: Macrobond

That’s not to say we are going to see an imminent taper. Employment levels in the United States remain more than 6 million lower than before the pandemic started while the latest Delta Covid wave adds another level of uncertainty that will justify the wait and see stance – although that only got a passing mention in the statement. We also have to remember that the Fed’s new monetary framework places a much greater emphasis on ensuring as many people in society feel the benefits of growth. This was accompanied by a move to an “average” inflation target of 2% and a clear signal that the economy will be allowed to run hotter than in previous cycles to ensure these targets are reached.

## Inching towards action

Nonetheless we are getting closer to action, as indicated by today’s language change, with a growing hawkishness creeping into the viewpoints expressed by several other FOMC members given the strong economy and the fact that inflation is running at more than double its 2% target. Already, the Fed’s own ‘dot plot’ chart of individual members’ predictions for the interest rate path has seven out of 18 FOMC members looking for a 2022 rate rise. It only takes three of the 11 members not favouring a 2022 rate hike as of June to switch sides to bring the medium in favour of action next year rather than 2023.

Obviously, talk is already underway about the tapering of the QE asset purchases. We expect to hear much more of this at the upcoming Jackson Hole Conference at the end of August.

Supply disruptions and labour shortages show little sign of abating and in an environment of strong stimulus fuelled demand this is leading to more persistent price pressures. It is also stifling the recovery story with expectations for tomorrow’s GDP growth figure having been scaled back due to the supply side of the economy not being able to fulfil all of the demand placed upon it with inventories continuing to be run down.

We expect the strong demand to story continue and with workers remaining in short supply, we see further wage pressure too. While several components that have been at the forefront of the rise in CPI (such as used car prices), are likely to reverse over time, rising housing costs are likely to be an increasing inflation pressure point that lead us to forecast that US headline inflation will stay above 4% until 1Q22 with core inflation unlikely to get below 3% until the summer of next year.

We also have to consider financial market conditions. The fall in 10Y yields from 1.7% to 1.25% is a big additional monetary stimulus for the US economy and is only likely to add to the nervousness of the more hawkish members of the FOMC.

## **An August signal for earlier action**

Given this backdrop, we expect the Jackson Hole Federal Reserve Conference to show Fed officials laying the groundwork for a QE taper with this fleshed out in more detail at the September FOMC meeting before being formally announced in December. We predict a relatively swift reduction that sees QE purchases end in the second quarter of 2022.

The June FOMC meeting saw officials shifting their collective view to a 2023 start point for interest rate increases after having previously been adamant it would not happen before 2024. With the economy continuing to grow strongly, inflation well above target and the jobs market looking strained through a lack of suitable workers there is the outside possibility that the median shifts to a 2022 start point for rate hikes when new projections are released in September. If so, this would then tally with our own view that we will start to see policy tightening get underway in September 2022 with a follow-up interest rate rise in December 2022.

## **Rates: A heavy dose of scepticism**

The Fed signalling progress on the criteria it will use to decide on tapering asset purchases was greeted with a counter-intuitive market reaction. As we have argued before, tapering is widely expected and there is only limited scope for the Fed to surprise the market either way. Instead, rates took the change in messaging as a signal that hikes, the next step on the Fed's tightening path, are coming up soon. In the current market mindset, this was also greeted with scepticism by rates, and the long-end flattened in a reaction that echoed that to the previous FOMC meeting in June. We do not think the gloom is justified, but current market conditions will persist for at least another month, and rates could yet print new lows in the coming weeks, and the curve should flatten further.

## **Fed keeping dollar's bullish sentiment alive**

A rather muted reaction in the FX market to the FOMC statement signalled that a slightly more hawkish message was largely priced in. Indeed, with the Fed that is inching closer and closer to tapering – there is a material possibility Powell will outline a timeline for reducing asset purchases at the Jackson Hole Symposium – markets should feel increasingly comfortable with pricing in a rate hike already in 2022. From an FX perspective, this should at least allow the recent good momentum for the dollar to continue.

With the Fed unlikely to turn into a negative factor for the dollar, it will be up to the global recovery story to change the tide in the FX market. For now, markets remain quite reluctant to re-price a flawless global economic recovery, and the recent bumps in Chinese sentiment may well have blown another hit to the already decreasing portfolio flows into emerging markets, which is another factor that should put a floor to the dollar in the short run.

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