

US: Does a “patient” Fed risk becoming a “complacent” Fed?

Jerome Powell's relaxed attitude to inflation signals no policy action anytime soon, but this could risk storing up trouble down the line



"Some time" before Fed action is coming

Jerome Powell has been interviewed at the Wall Street Journal Jobs Summit on a range of issues relating to the economy, but the main take-away is that the Fed remains in no hurry to shift its position that inflation is likely to be “transitory” and if that is the case they can be “patient”. They won’t change policy until there is “substantial further progress” and this could take “some time”.

The March 17 FOMC meeting will be a non-event

This confirms that the March 17 FOMC meeting will be a non-event with the Fed firmly in holding pattern despite the positive news on vaccines, the prospect of significant further fiscal stimulus and a very strong start to the year for the economic data.

Chair Powell emphasized the Fed's dual mandate and how it has changed as a result of their long-term strategy review – emphasizing “shortfalls” rather than “deviations” as in the past on employment and the move to “average” inflation targeting.

While he accepted there is good reason to expect a job pick-up, “we need it” as there are still 10 million people fewer in work than before the pandemic struck. To get “substantial further progress” he would need to see wages picking up and broad-based gains in employment – they won’t just be looking at the unemployment rate. We won’t get to full employment this year, but he is hopeful that the economy can make “good progress”.

Inflation set to be "transitory"

Regarding inflation he commented that it remains below 2% and they can tolerate an overshoot. Moreover, it is important to keep inflation expectations anchored at 2%. Combining this with the fact that so many people remain without a job he argued that the Fed are still “a long way from our goals”.

He acknowledged that inflation will pick up as the economy re-opens, but the key question is will the pressures “be sustained or transitory?” The US has experienced a low inflation world for the past decade and it is unlikely that “deeply ingrained” low inflation will fade fast. This, we would suggest implies a belief at the Fed that it will indeed be transitory and if so they “will be patient”. This means no near-term taper talk regarding the \$120bn of monthly QE asset purchases. It also means the Fed dot plot diagram, which is updated on March 17, will continue to suggest no rate hike before 2024.

What if it is actually different this time?

Everyone acknowledges that inflation will rise over coming months – we will be comparing price levels in a depressed, lockdown impacted economy during the depths of the pandemic last year with price levels in a (hopefully) re-opened vibrant economy through 2Q21 onwards. An economy that is benefiting from pent-up demand, a much improved household balance sheet, a \$1.9tn fiscal stimulus and ongoing support from monetary policy. Throw in supply constraints in many industries, rising energy costs, supply chain disruptions as we work through the re-opening, surging freight costs and the prospect that the booming housing market translates into sharply higher housing inflation components over the next 18 months – remember housing is 33% of the CPI basket!

We do get a sense that there is a hint of complacency on inflation forecasts in general

While we are always loathe to say “it will be different this time” we do get a sense that there is a hint of complacency on inflation forecasts in general. Perhaps it is because there have only been 13 occasions since the end of 2008 that the Fed’s favoured measure of inflation – the core PCE deflator – has risen or even just hit 2%. This is less than a 10% success rate for the Fed over the period. We feel that the ingredient that feeds into inflation looks much richer than at anytime over the past two decades. Get a minimum wage hike that sets the ball rolling on a bit more wage inflation and “patience” could run the risk of starting to look a little like “complacency”.

We released new economic and market forecasts earlier today and are now projecting that the US will grow 6.5% in 2021 with inflation averaging 2.9%. We look for growth of 4.7% next year with

inflation staying at 2.9%. The comments from Jerome Powell suggest that the Fed is more cautious and we admit that we are certainly above consensus too, which according to Bloomberg is 5% for annual GDP and 2% for CPI this year.

Understandably we look for the Fed to hike earlier (3Q23) and for bond yields to remain under upward pressure – targeting a 10Y of 2% by year end.

Treasury market implications

From a bond and market rates perspective, the key take-away is that Chair Powell is prepared to let inflation take off, and is unlikely to take action in the face of that, unless it gets out of control. The problem is we won't know whether it is in or out of control until we let it rip a bit. That's quite an uncomfortable set of circumstances from the point of the fixed income investor, and especially for longer tenors, the value of which can get quickly eaten away by inflation.

A move higher in long rates has been the impact reaction, and it would not surprise us if this was followed through with more rises in the weeks ahead. Also, we have a week of long duration auctions to get through next week, which will prove a real test of where sentiment is. Meanwhile, the front end remains absolutely anchored, meaning more curve steepening. And the 5yr part of the curve has started to cheapen again to the curve, pointing to an upside bias for longer term rates on the back of all of this.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10

Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.