FLASH NOTE

PICTET WEALTH MANAGEMENT
ASSET ALLOCATION & MACRO RESEARCH
15 March 2021

FOMC PREVIEW – WE NEED A TEACHER AND A PLUMBER

'MISBEHAVING MARKETS' MIGHT NEED A LESSON, BUT FOCUS COULD BE ON THE PLUMBING

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SUMMARY

- The 16-17 March Federal Open Market Committee (FOMC) meeting should reveal that the Federal Reserve still sees no need to hurry tightening despite the passage of President Biden's USD1.9 trn stimulus package.
- The central bank's summary of economic projections could show its expected first rate hike brought forward to Q4 2023, but that would still be one year later than is currently being priced in by money markets. A big gap will therefore persist between market and Fed expectations.
- Fed chairman Jerome Powell could put the spotlight on some important market 'plumbing' issues amid rising long-term rates but high liquidity at the short end.
- A crucial issue is commercial banks' supplementary leverage ratio (SLR): a waiver on banks' requirement to respect this ratio ends on 31 March. With fears that debt demand from banks will drop going forward, markets are clamouring for a partial extension of the SLR waiver.
- While much less likely, the Fed could also cite technical/plumbing issues to launch 'Operation Twist', increasing the duration of its bond purchases.
- The biggest issue for the Fed right now is that the markets do not seem to believe in Powell's signature policy of 'average inflation targeting', which implies no tightening for a prolonged period. Markets seem to have more faith in a Greenspan-esque / classical Taylor rule-type reaction function that foresees the Fed tightening rates when inflation is in the vicinity of 2%, just like in the 'old days'. In other words, the Fed's new approach to inflation and its monetary stance in general are facing considerable credibility challenges.
- As a reminder, the 'new' Fed strategy allows for increased tolerance of higher inflation, partially as a trade-off for other considerations such as improving social cohesion and limiting inequality. The unemployment rate among minorities is a particular focus for the Fed these days.
- In addition, the Fed may have to take on additional mandates later. Just like the Bank of England, it may be called upon to support the 'green transition'. All these factors, as well as the burden of debt post covid-19, mean that the Fed is indeed more constrained when it comes to raising rates than the market currently perceives. We are not in the 1990s anymore. Powell will have to do more to 'educate' the markets on this point on 17 March.
- We continue to believe that it is premature for the market to be pricing in a first hike of the fed funds rate for late 2022. Like the Fed, we think a rise in inflation this spring is likely to be temporary. But the bond market could continue to test Powell if he does not provide a strong defence of the Fed's 'average inflation' strategy and explain what it means in practice.

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Money markets are pricing the first Fed rate hike in December 2022

The Federal Reserve meets for its regular Federal Open Market Committee meeting on 16-17 March, with its decisions and new economic projections released on 17 March, followed by a press conference. The backdrop is one of an improving US economic outlook due to two important factors. One is the passage of Biden's USD1.9 trn fiscal package, which is heavily focused on boosting household demand (through fresh cheques to households and an extension of unemployment benefits).

The second is the fast acceleration of the US vaccination effort, leading to the prospect that the US economy fully re-opens sooner than expected, even though the official line is still one of prudence: President Biden said he only expected a return to 'partial' normalcy by Independence Day on 4 July.

With US growth forecasts for 2021 being revised up by markets (on our side, we expect GDP to grow 5.6%, with tangible upside risk), money markets see the first Fed rate hike coming into view much quicker than they had expected a few weeks ago: They are now pricing in the first rate hike somewhere around December 2022.

While the Federal Reserve has adopted a rather benevolent and patient view of the economic and fiscal backdrop, it is coming under sizeable pressure to become more reactive as market interest rates go up. There is a good chance that the Fed's internal consensus projections change to show a single rate hike by 2023 (versus predictions of no rate increases in 2023 in the projections compiled in December).

This would still be one year later than is currently being priced in by money markets.

In any case, the Fed's new 'average inflation targeting' strategy, unveiled last summer, is coming under scrutiny like never before. The new strategy shows the Fed adopting a more dovish reaction function than in the past. In other words, the Fed is willing to tolerate a higher rate of inflation over a certain period—not only because inflation has undershot for several years but also because of evolving Fed priorities. Nowadays, the Fed pays more attention to social 'inclusiveness', a path that Janet Yellen, now Treasury Secretary, started to tread when she was Fed chair. Thus, beyond overall unemployment, the Fed has been watching the unemployment rate among minorities as well as developments in the US labour force. In coming years, it is not unthinkable that the Fed be handed a new mandate to help the transition to a 'greener' US economy. This could involve (once again) keeping interest rates low and predictable.

In recent weeks, the Fed has repeatedly said there is no rush to hike interest rates, a point made again by Powell during his February semi-annual congressional testimony. The Fed has also made clear that it is not in a hurry to reduce its monthly government debt purchases (currently running at USD120 bn per month) because of lingering risks over the recovery, including the risks posed by new virus variants – or the global growth backdrop. Like us, the Fed also believes that the boost to inflation from Biden's fiscal package and the sharp rise in commodity prices will be only temporary given there will remain deep-seated disinflationary forces (such as globalization, technology, inequality and demographics).

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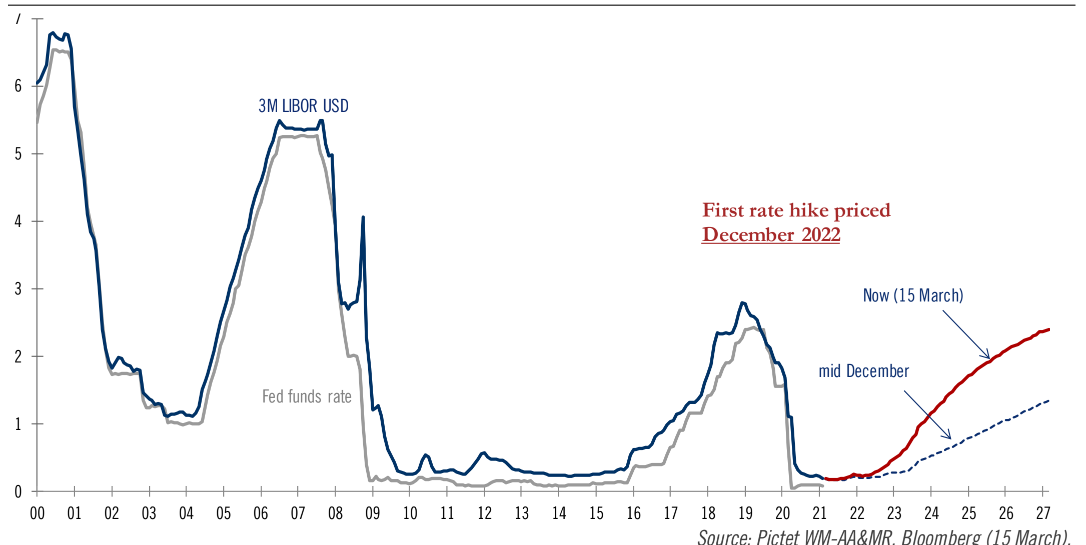
The problem is that the recent sharp rise in bond yields shows not just "improving growth prospects" but also the market's willingness to test the Fed's commitment not to hike rates for a prolonged period.

Very probably, Powell's response to this challenge will be indirect, with a focus on market "plumbing" issues when he speaks on 17 March. One important issue is the waiver on commercial banks' supplementary leverage ratio (SLR) that was announced at the height of the covid-19 shock. There has been surprisingly little communication on what comes after the waiver expires on 31 March. Markets are clearly putting pressure on the Fed to grant at least a partial extension to the waiver so that banks can continue to accumulate government debt.

Another important technical issue is the overabundance of liquidity in money markets. In particular, the US Treasury will cut its 'Treasury General Account' (the government's 'war chest' held at the Fed) since the Treasury borrowed too much last year to meet its actual needs. But this is leading to fears of a new increase in bank reserves at a time of quasi-saturation. In a sense, it would make sense from a technical perspective if the Fed's quantitative easing (QE) focused on buying more longer-term paper ('Operation Twist'), since short-term US Treasury bills are already in very high demand from the private sector.

Still, beyond the technical/plumbing issues, we will be scrutinising Jerome Powell's defence of the average inflation targeting strategy and its patience regarding the first rate hike. In contrast to his relatively relaxed stance up to now, we believe that Powell's assessment of the rise in yields could be more nuanced at the 17 March press conference. Rising long-term yields may be posing a more sizeable risk to the US economy than Powell has recognised up to now.

CHART 1: MONEY MARKETS ARE PRICING THE FIRST RATE HIKE BY DECEMBER 2022. IT SEEMS TOO EARLY



Source: Pictet WM-AA&MR, Bloomberg (15 March).

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Disorderly moves in bond yields could destabilise financial markets and the recovery. With total public and private debt now standing at nearly 300% of GDP, the US economy's sensitivity to interest rates is now higher than ever. In particular, further sharp rises in mortgage rates could undermine the housing sector, which has been a vital element of the US recovery so far.

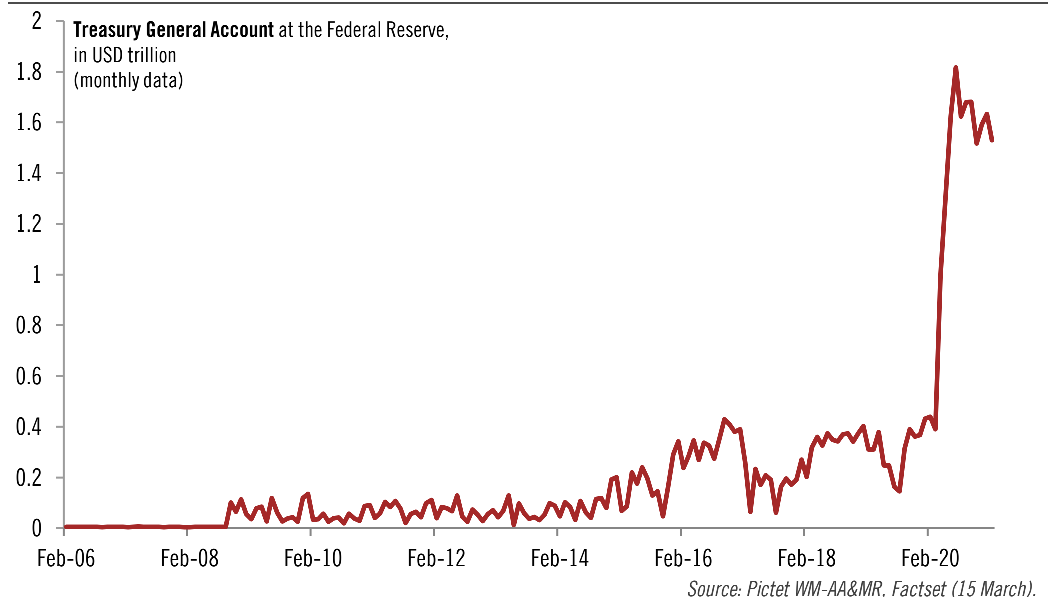
Meanwhile, it is far from clear that the trajectory for potential output (potential GDP) has moved up post Covid, and that the theoretical 'neutral' rate (used as a benchmark by the Fed to calibrate its 'stance') is going up as well. In that regard we will watch in the SEP whether the Fed's forecast for the interest rate in the longer run evolves (we doubt).

All this said, we do not expect the Fed to make any big announcement such as the formal introduction of yield curve control. Nor we do not expect an increase in monthly QE purchases.

Unlike the money markets, we do not think a Fed rate hike is likely in late-2022. Base effects as well as sharply rising commodity prices are impacting inflation forecasts for this year, but next year will be a different story amid likely slowing fiscal support. Crucially, we do not see a feedback loop in wages. While US growth could be back in line with its long-term 'potential' this year already, the labour market is more important when it comes to inflation forecasting. We expect the labour market to improve more slowly than GDP.

The Fed's prudent stance not only reflects greater tolerance for higher inflation but also, in our view, a list of old and new constraints that make tightening much more difficult to consider than in the past. This includes the big burden of public and private debt (amplified by the covid-19 shock), the unstated requirement to help fund the government budget deficit and the likelihood the Fed will have new priorities ahead, such as supporting the 'green' transition. We therefore think that US fed funds rates will stay low for longer than money markets are currently pricing.

CHART 2: A POTENTIAL PLUMBING ISSUE: BANK RESERVES WILL GO UP FURTHER AS T.G.A. IS SET TO DROP



Source: Pictet WM-AA&MR, Factset (15 March).

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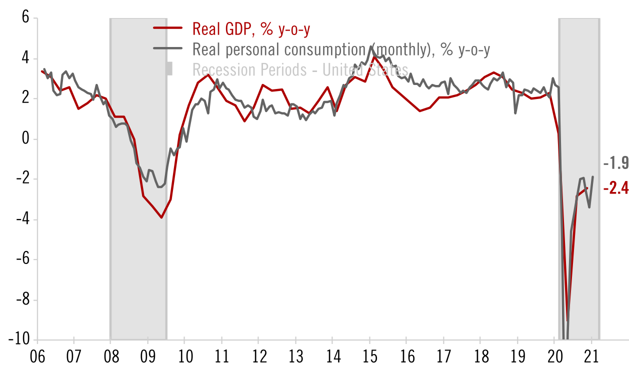
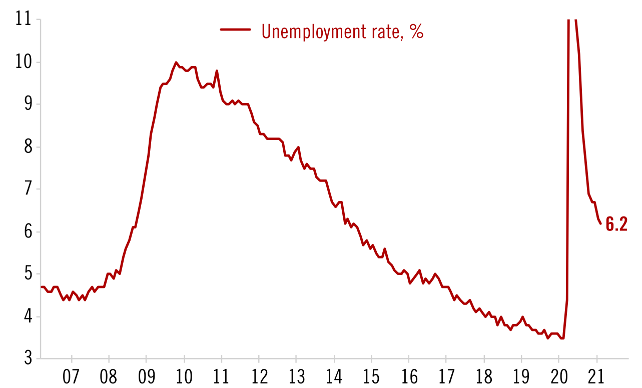
REAL GDP AND PRIVATE CONSUMPTION GROWTH, % Y-O-Y



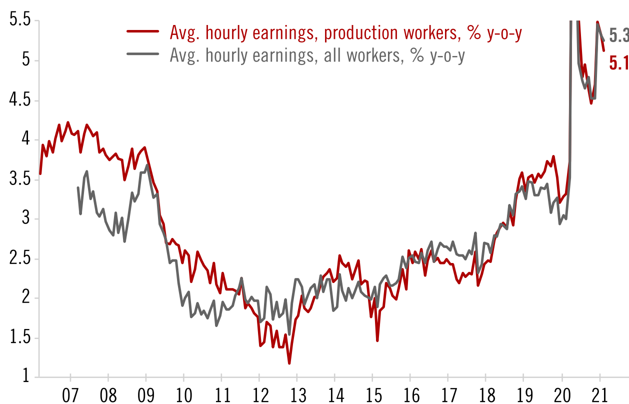
Source: Pictet WM – AA&MR, Factset

UNEMPLOYMENT RATE, %



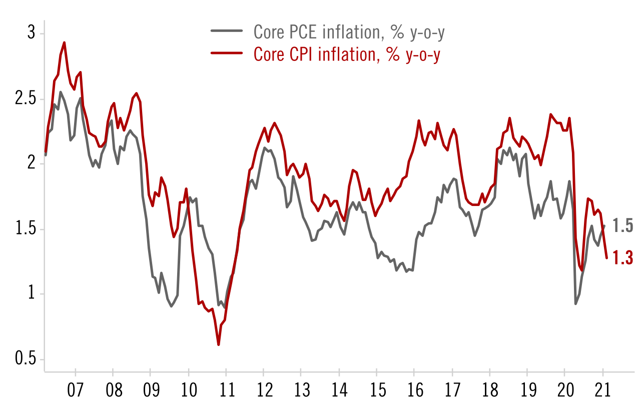
Source: Pictet WM – AA&MR, Factset

AVERAGE HOURLY EARNINGS (WAGE GROWTH), % Y-O-Y



Source: Pictet WM – AA&MR, Factset

CORE INFLATION (PCE AND CPI), % Y-O-Y

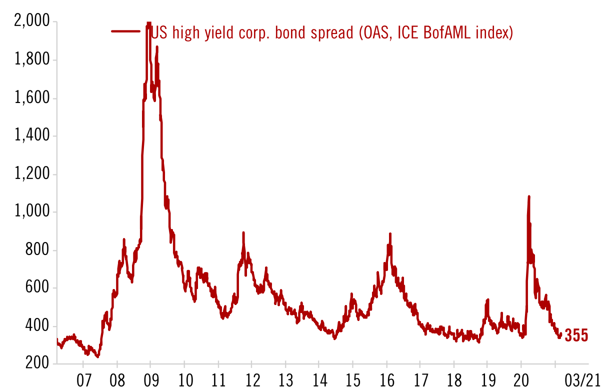


Source: Pictet WM – AA&MR, Factset

ISM BUSINESS SURVEYS

Source: Pictet WM – AA&MR, Factset

HIGH-YIELD CORPORATE BOND SPREAD, BASIS POINTS



Source: Pictet WM – AA&MR, Factset (last close)

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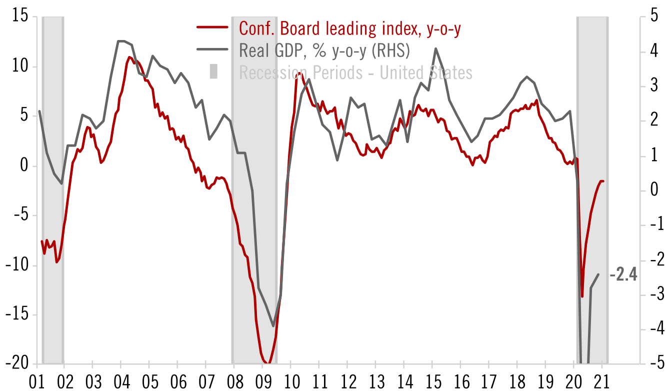
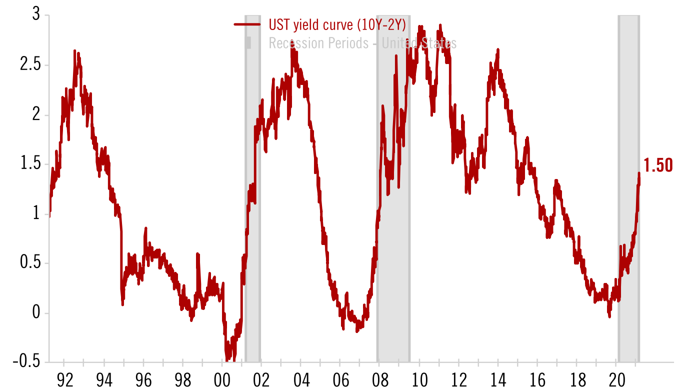
CONF. BOARD LEADING INDEX, % Y-O-Y VS GDP GROWTH, % Y-O-Y



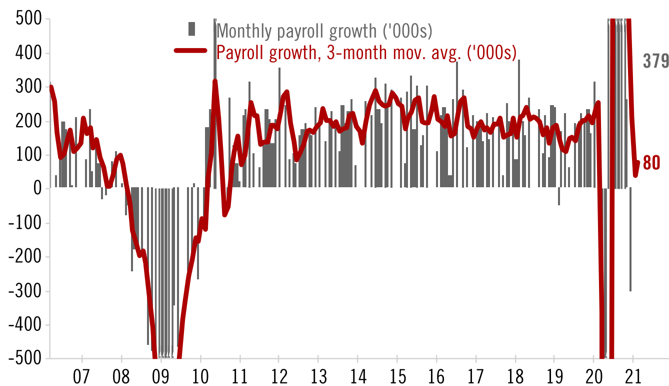
Source: PWM - AA&MR, Factset

US YIELD CURVE SPREAD (10-YEAR YIELD MINUS 2-YEAR YIELD)



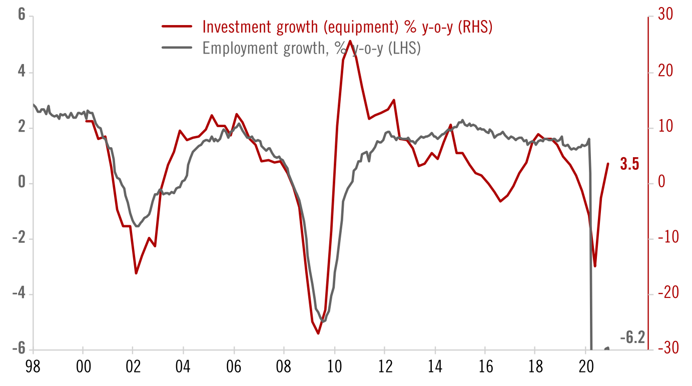
Source: PWM - AA&MR, Factset (last close)

EMPLOYMENT GROWTH, IN THOUSANDS



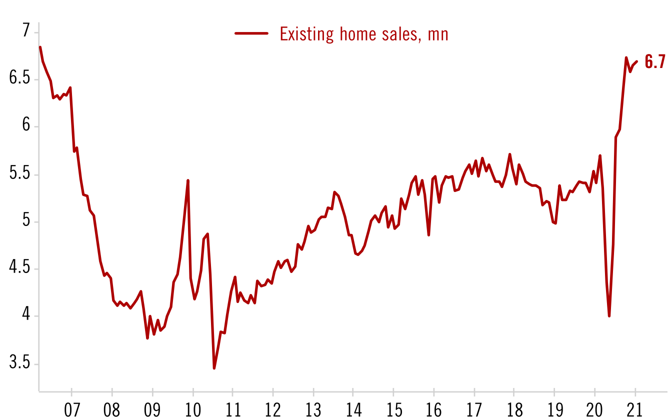
Source: PWM - AA&MR, Factset

US INVESTMENT (EQUIPMENT) VS EMPLOYMENT GROWTH, % Y-O-Y



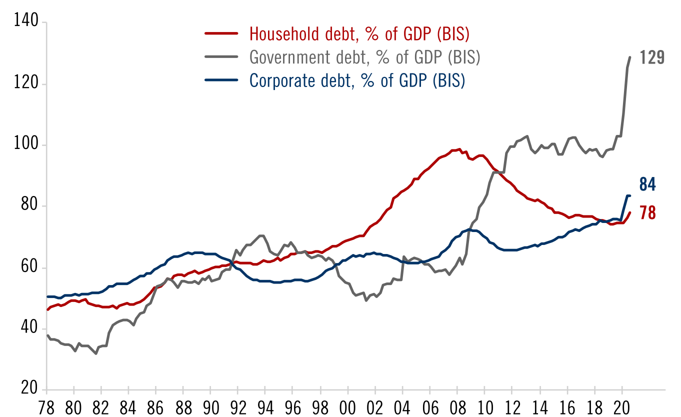
Source: PWM - AA&MR, Factset

EXISTING HOME SALES, MILLION UNITS (ANNUALISED)



Source: PWM - AA&MR, Factset

DEBT RATIOS (HOUSEHOLD, CORPORATE, GOVERNMENT), % OF GDP



Source: PWM - AA&MR, Factset

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