PICTET WEALTH MANAGEMENT
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FOMC PREVIEW – PATIENCE IS THE WORD

DESPITE SHARP REBOUND IN US ACTIVITY, FED LIKELY TO STILL SEE GLASS HALF EMPTY

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SUMMARY

- At its regular policy meeting to be concluded on 28 April, we predict that the Federal Reserve (Fed) will once again avoid sending signals about the coming reduction of its bond purchases, currently running at USD120 bn per month.
- This is despite now-tangible signs of a sharp improvement in US growth, itself linked to solid progress on vaccination and robust federal-budget support.
- Our baseline scenario is that the Fed will start giving explicit hints in the second half of the year about an effective reduction of QE in Q1 2022. The Fed's agenda could accelerate though, especially if payroll growth remains in the vicinity of 1 million per month throughout the current quarter. In fact, jobs will matter more than GDP.
- Money markets continue to doubt that the Fed will wait until 2024 to move up interest rates from the current 0-0.25% range: They are pricing the first rate hike at around December 2022.
- But we would tend to side with the Fed on this question, seeing the first rate hike in 2024.
- The 'average inflation targeting' strategy does show more Fed tolerance for a rise in inflation above 2%—but there are other dimensions to the Fed's dovishness that go beyond mere inflation. The Fed is also indirectly assisting in keeping borrowing costs low for the government but also for corporates. It is also watchful of socio-economic developments like unemployment among minorities, and soon could put more importance on the green energy transition. The stacking up of these new implicit mandates mean more protracted policy accommodation and the possibility that the Fed moves the goalposts further as it resists 'true' monetary tightening.

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QE taper: The word is patience

The Federal Reserve's dovishness, and particularly its **ability to perennially see the glass as half empty**, should be once again on full display on 28 April when Chairman Powell conducts his now-traditional press conference after Fed policy meetings. We predict **Powell will once more refrain from giving a timeline for reducing and ending the Fed's bond purchases**, which continue at a monthly pace of USD120 bn/month (of which USD80 bn are in the form of Treasuries and USD40 bn in mortgage-backed securities).

While the US vaccination efforts have been impressive in recent months, Powell is likely to highlight his concern about **virus variants and the still-unsettled sanitary situation at the global level**. And while monthly jobs growth of nearly 1 million in March shows that the US economy has been opening swiftly, Powell is likely to highlight that there are still 8 million less people at work today than before the pandemic.

While not necessarily bringing much news, this meeting will be a good reminder on **how structurally accommodative the Fed is**, as well as on its formidable capacity to cherry pick data supporting its stance (some say even move the goalposts).

To be sure, this accommodative stance has deep roots, stretching back to Alan Greenspan and including some inclination to believe that buoyant financial markets will have a cascading wealth effect throughout the US economy. **The Fed's inherent dovishness has received a further shot in the arm under Powell's chairmanship**. Powell has shown some solid pragmatism and a capacity to invert the burden of the proof when it comes to the need to tighten policy. Powell has been indirectly signalling that the path of least resistance is by definition low, if not, zero interest rates. (The dovishness of his predecessor, Janet Yellen, was more anchored in economic models. While Powell is still as dovish, if not more than Yellen, he has distanced himself from these economic models).

Officially, the Fed's strategy since last summer is "average inflation targeting" strategy, adapting the "flexible inflation targeting" employed in recent decades in a context of structural disinflation. Overall, **we think the name tag ill conceals a Fed that is being increasingly overburdened with implicit mandates that mean it has to stay dovish**.

These include the tacit assistance in keeping the federal government's borrowing costs affordable (and even more so with Yellen now in command at Treasury). Another dovish impulse comes from the Fed's strong penchant to consider socio-political issues beyond pure monetary economics, such as unemployment among minorities (perhaps to be followed by concerns for 'green energy' issues). Lastly, we believe there is some underlying fear about rising interest rates given the sharp rise in corporate indebtedness (which we call a 'debt dominance' monetary regime). All this 'do no harm' approach means continued accommodation on the part of the Fed as problems are left for later.

The Fed also shows limited concern about the side effects of its policy accommodation. In fact, the Fed seems to be suggesting in some way that it is almost powerless to change deep-seated disinflationary trends and that inflation, if it comes, will be just transitory. **Markets seem to believe more in its ability to reinvigorate inflation than the Fed itself**. Regarding the risk that easy money spills over into financial markets and create distortions, the Fed's stance oscillates between naivety and a belief that banking

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regulation will take care of fragilities in the financial system – again a stance which echoes Greenspan's era.

Our Fed scenario: Still no rate increase before 2024

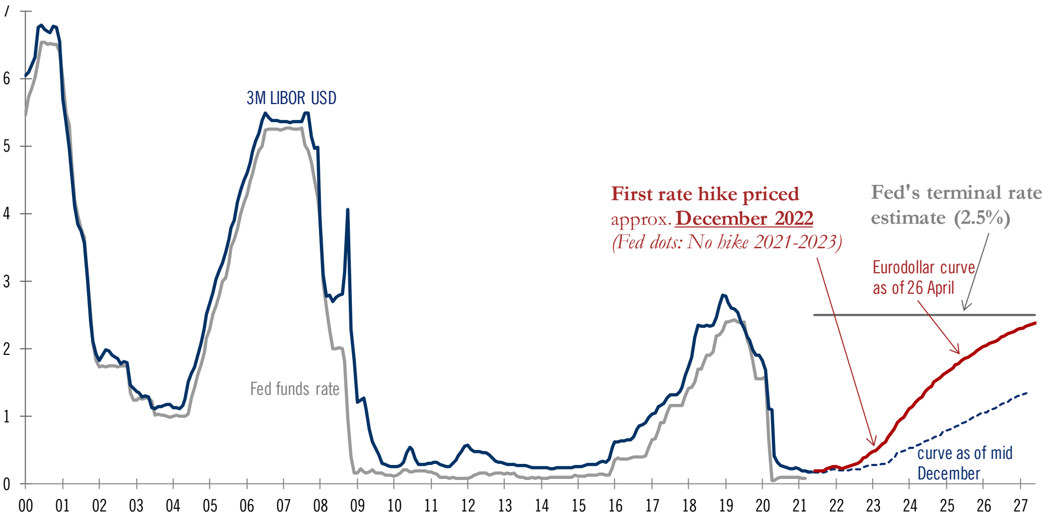
Our baseline scenario is still for the Fed to start dropping hints about tapering its asset purchases later this year. We do not expect tapering to begin before Q1 2022, but there is a risk it could indeed start earlier. **Job growth will matter more than GDP itself in any Fed tapering decision**, we think, with the Fed anxious to see whether payroll growth can be sustained at around 1 million per month throughout Q2 (we expect some moderation).

The vaccination picture could also be instrumental for the taper agenda. St Louis Fed president James Bullard would like to tie tapering to a 75% vaccination rate, which could be reached by July/August. However, Jerome Powell has not seemed to endorse this proposal in his recent public interventions, preferring to avoid any fixed target that could tie the Fed's hands. Also, Powell remains sensitive about the risks posed by **virus variants**. He may want to see more medical data on that front—which again would call for more patience.

Another parameter will be fiscal policy, and especially whether President Biden can push through all his enormous spending plans. On that front, we continue to think that Congress will take its time to examine Biden's proposals, and while more spending could be in the offing, we would not expect Congressional votes until after the summer.

Our baseline scenario is that the Fed will raise its base rate in mid-2024 and will increase it gradually thereafter. Indeed, we think the Fed will likely aim for a slow convergence of its base rate to the estimated 'terminal rate'. This is currently estimated to be 2.5%, but could be revised down in future years due to structural factors affecting the US and global balance of savings and investment (ageing, technology, globalisation, financialization).

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



Source: Pictet WM-AA&MR, Bloomberg (26 April).

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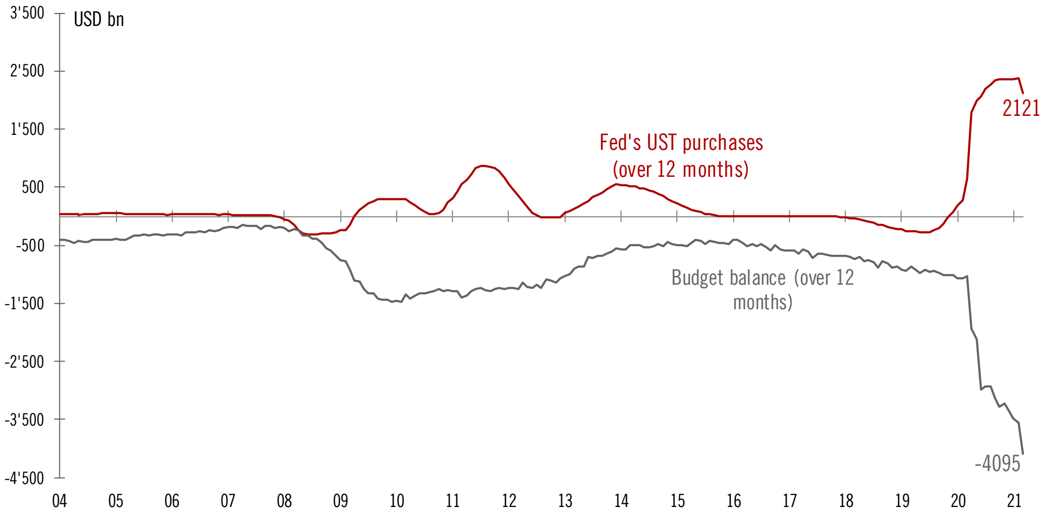
The Fed-watcher's corner: Tweak the interest rate on banks' excess reserves?

Fed watchers will closely scrutinise whether there is a tweak to the interest rate on excess reserves. We do not expect one. To put the debate in context, the issue is that the money markets are overwhelmed with liquidity right now, in part due to the Fed's ongoing sizeable bond purchases (the automatic effect being a sharp rise in bank reserves at the Fed), and in part due the Treasury's decision to run down its 'Treasury General Account' at the Fed (which automatically leads to higher bank reserves too).

The fed funds effective rate (the rate at which banks trade their reserves) is closer to the bottom of the 0-0.25% 'official' range as it's been trading at around 0.07% in recent days; such softness has spread to other market rates and notably Treasury bills. The question has therefore arisen as to whether artificially push to put the effective rate closer to the mid-point of the target, which could be done by raising a bit the interest rate on excess reserves (set at 0.10% since March 2020). Overall, we do not think the Fed cares that much at this stage and it could end up a communication headache. **A 'first do no harm' approach on this front, as it traditionally does on other matters, would call for the status quo on IOER.**

CHART 2: THE FED IS LIKELY TO REDUCE ITS BOND PURCHASES (QE) GRADUALLY



Source: Pictet WM-AA&MR, Factset (updated 26 April – data as of March 2021).

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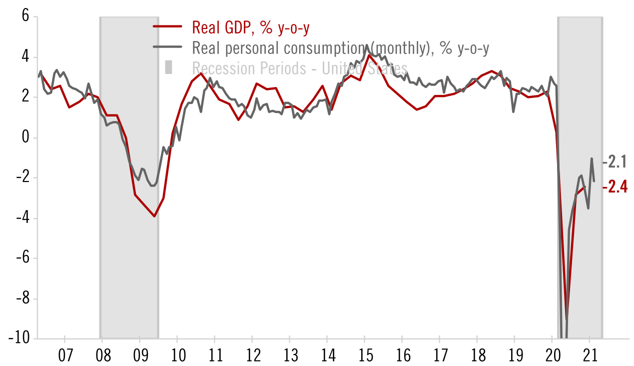
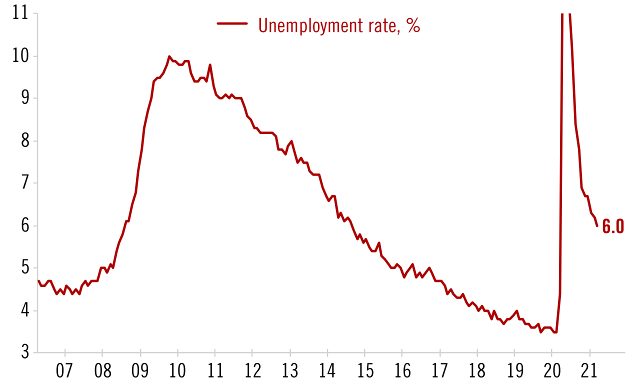
REAL GDP AND PRIVATE CONSUMPTION GROWTH, % Y-O-Y



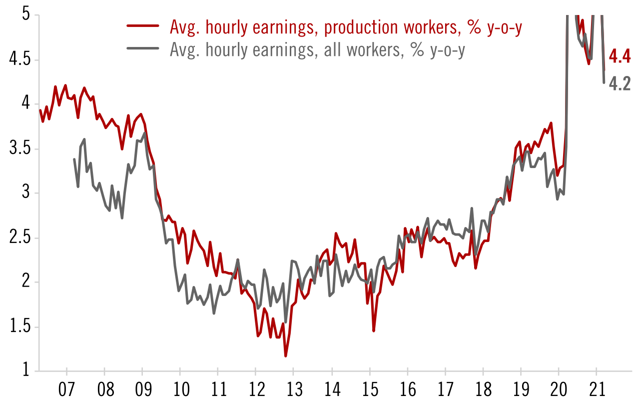
Source: Pictet WM – AA&MR, Factset

UNEMPLOYMENT RATE, %



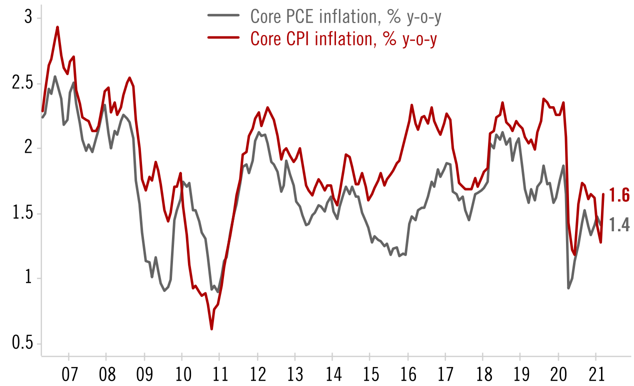
Source: Pictet WM – AA&MR, Factset

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



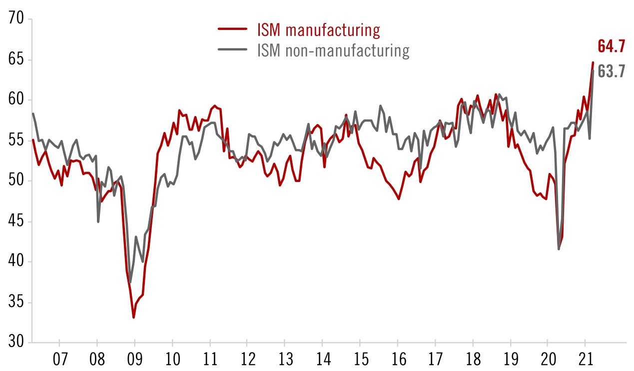
Source: Pictet WM – AA&MR, Factset

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



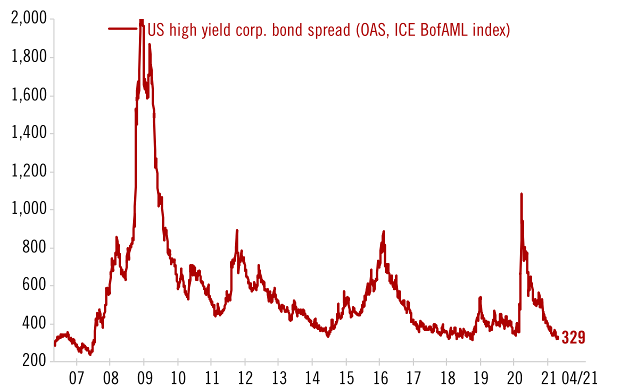
Source: Pictet WM – AA&MR, Factset

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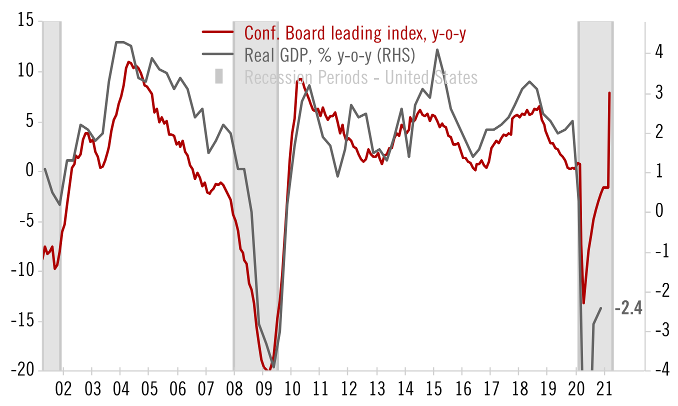
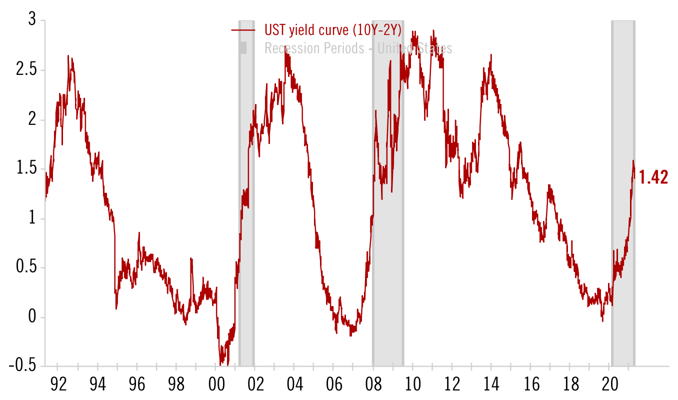
CONF. BOARD LEADING INDEX, % Y-O-Y VS GDP GROWTH, % Y-O-Y



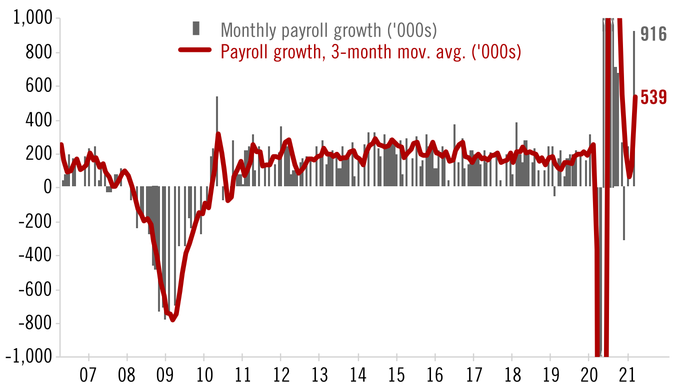
Source: PWM - AA&MR, Factset

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



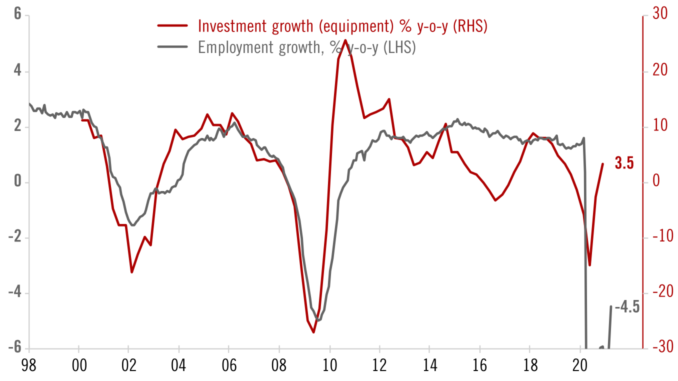
Source: PWM - AA&MR, Factset (last close)

EMPLOYMENT GROWTH, IN THOUSANDS



Source: PWM - AA&MR, Factset

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

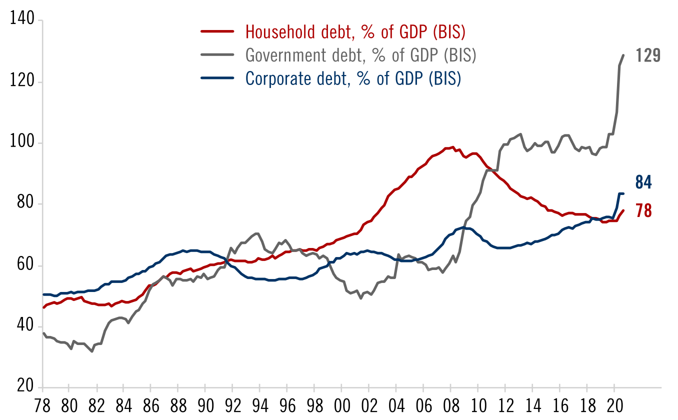


Source: PWM - AA&MR, Factset

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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