PICTET WEALTH MANAGEMENT
ASSET ALLOCATION & MACRO RESEARCH
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JULY FED MEETING PREVIEW

TORN BETWEEN DELTA VARIANT CONCERNS AND SHARPLY RISING HOUSE PRICES

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SUMMARY

- At its regular policy meeting next week, Federal Reserve Chairman Jerome Powell is likely to repeat that a reduction in the Fed's monthly bond purchases (currently USD120bn/month) is still "ways off".
- While the spread of the Delta coronavirus variant could be a worry, the sharp rise in house prices (fueled by very accommodative financial conditions) will likely keep the Fed's plans for a QE taper on track.
- The recent sharp acceleration in inflation is still likely to be judged a temporary phenomenon, driven by very specific factors such as supply bottlenecks caused by re-opening.
- Our scenario is still for a QE taper to be formally announced at the December meeting, and to effectively commence in January 2022. The risk is still for an earlier start, although September looks premature given potential congressional battles that month about the debt ceiling and the federal budget.
- Jerome Powell could send more precise signals about the Fed's intentions at the 27-28 August Jackson Hole conference once he is assured that the labour market is continuing to recover solidly and that the Delta variant is not damaging the recovery.
- We think the Fed will voluntarily stay 'behind the curve', continue to ignore high inflation prints for several quarters, and only hike interest rates in December 2023. We expect subsequent rate hikes to be slow, with the Fed keeping interest rates below the rate of inflation for several years as it confronts high debt loads and political pressure to keep policy loose.

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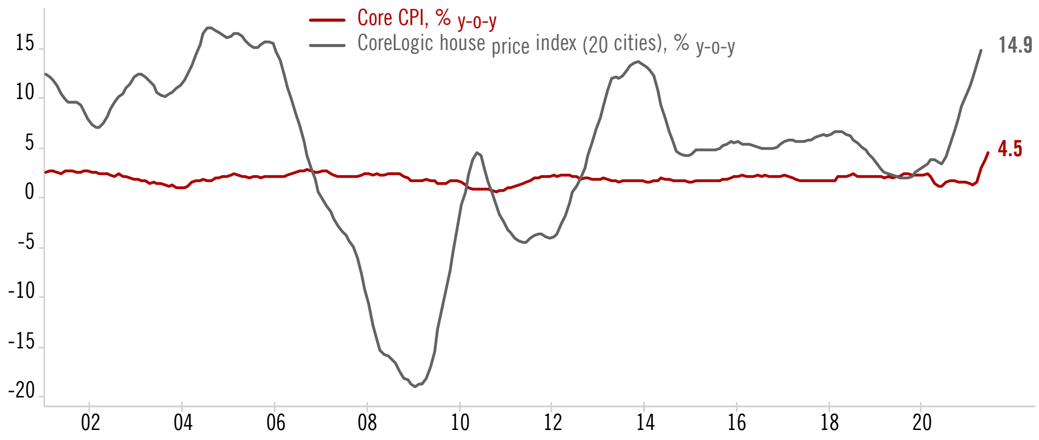
Sharply rising house prices could be an important focus

We expect the Federal Reserve (Fed) to stick to its knitting at the July meeting and still indicate that a **QE taper is still "ways off"** (the term used by Jerome Powell at the previous Fed meeting), indicating that QE taper is a late-2021/early 2022 story.

We do not see the **Delta variant** interrupting the Fed's plans for tapering its asset purchases. In fact, we think the **unabated rise in house prices** (confirmed by the latest figures for June) will keep the Fed on track to soon start reducing its monthly asset purchases. In other words, we think **concerns that financial conditions may be too loose will outweigh fears about the Delta variant of covid-19**. The Fed is surely observing the situation in the UK, where, thanks to widespread vaccination, hospitalisations have not noticeably increased despite the rapid rise in new variant infections.

CHART 1: SHARPLY RISING HOUSE PRICES JUSTIFY SLOWING ASSET PURCHASES



Source: Pictet WM-AA&MR, Factset, 23 July 2021.

We do not think Jerome Powell will repeat that a QE taper is being "actively considered" (the term he used in congressional testimony this month, probably inadvertently). But the term could resurface at the Jackson Hole conference, by which stage we will have more data on job growth. If, however, Powell next week repeats that tapering is being "actively considered", then there could be an increased chance we see tapering starting in September.

To be sure, the political situation means we think a September taper is unlikely, because it would clash with debates in Congress about the debt-ceiling as well as various budget items. We think the Fed will wait out these debates, just as it did in 2013 when there were similar debt-ceiling and budget-funding issues.

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Fed scenario: Still expecting the first rate hike by December 2023

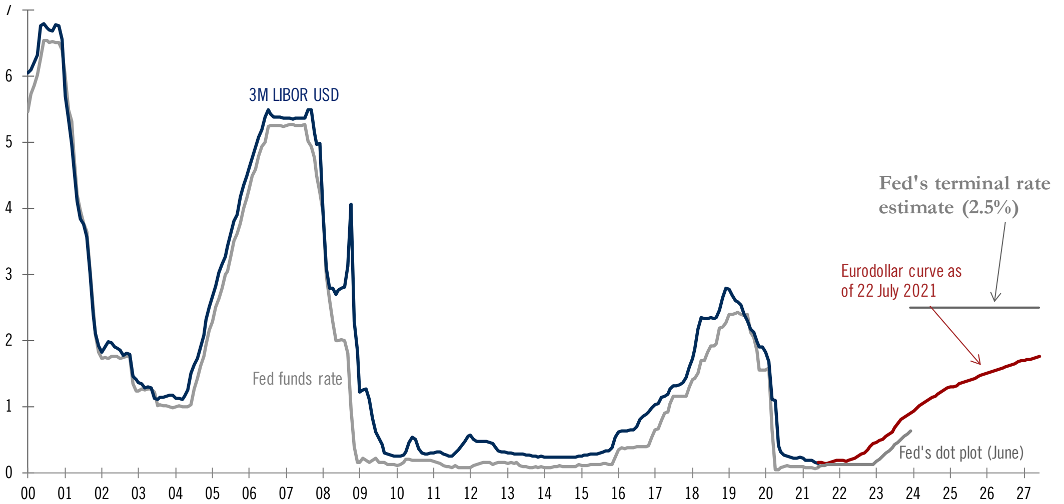
All in all, we believe the Fed will start signalling tapering at Jackson Hole at the end of August, with an **official announcement in December** and a formal start to tapering in January, although it could start a few weeks earlier. The reductions in asset purchases will be in increments of USD10 bn per month, in our view, which means that the winding down of the Fed's asset purchases will last throughout 2022. We think the first reduction will fall equally on mortgage-backed securities and US Treasuries. **We interpret tapering as a move by the Fed to become less accommodative, but not an actual tightening of its monetary policy.**

Tapering will also be guided by the 'plumbing'. Money markets seem saturated with liquidity as all new liquidity injected by the Fed seems to revert back to the Fed via the reverse-repo facility (with a take-up close to USD 900bn at the moment).

We believe the Fed will continue to look past headline inflation prints above 2% for several months and to focus instead on labour-market signals before it starts to consider hiking interest rates. This means waiting until the end of 2023, as long as the labour market is functioning to the Fed's satisfaction at that stage. In other words, **we continue to think the Fed will remain growth and market friendly and 'behind the curve' when it comes to inflation**. We expect a first rate hike by December 2023, followed by further, very gradual, and mostly symbolic rate increases. We continue to think the **Fed will leave its benchmark interest rates below its 2% inflation target in the coming years**.

Our Fed view is still posited on our belief that there are **immense political and financial-market barriers to *true* monetary tightening** (in other words, inflation-adjusted interest rates that turn positive). We think the Federal Reserve will continue to ignore the potential negative side-effects of constant policy accommodation (ranging from the risk of asset bubbles to potential misallocation of capital and rising inequality). In fact, we think the Fed could even envisage new ways to stay accommodative and keep easy money flowing into the US financial system. For example, work on a digital currency could put money directly into consumers' pockets.

CHART 2: THE MARKET STILL EXPECTS EARLY TIGHTENING



Source: Pictet WM-AA&MR, Bloomberg, 23 July 2021.

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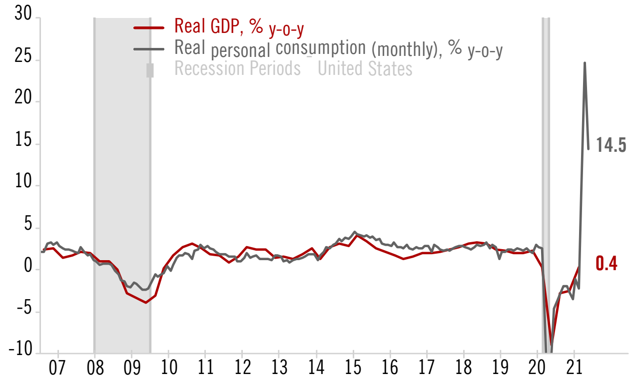
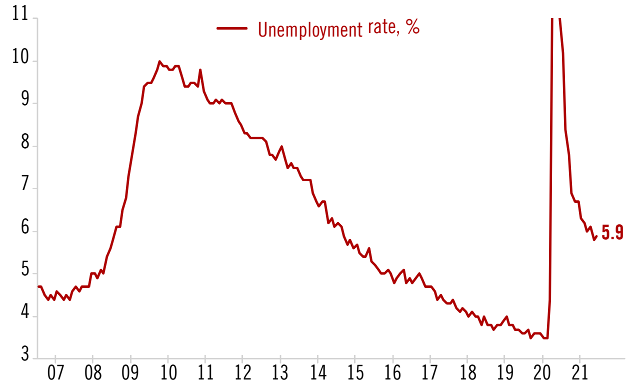
REAL GDP AND PRIVATE CONSUMPTION GROWTH, % Y-O-Y



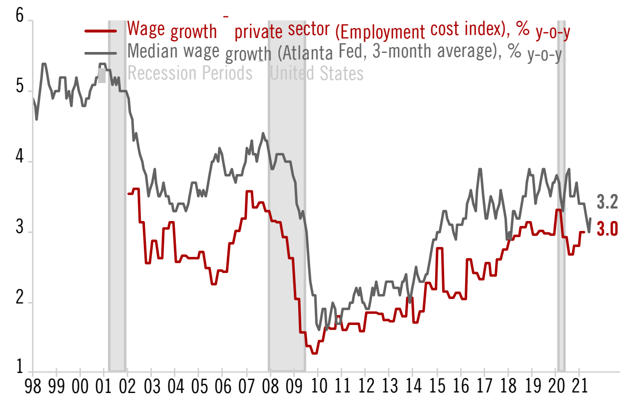
Source: Pictet WM – AA&MR, Factset

UNEMPLOYMENT RATE, %



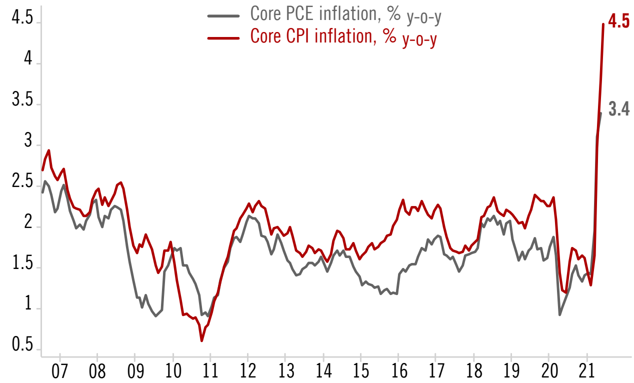
Source: Pictet WM – AA&MR, Factset

WAGE GROWTH INDICATORS, % Y-O-Y



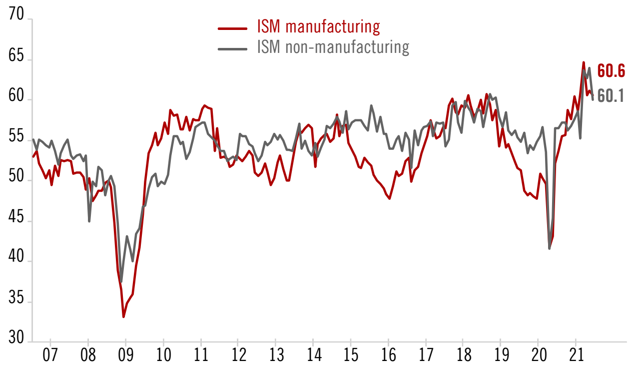
Source: Pictet WM – AA&MR, Factset

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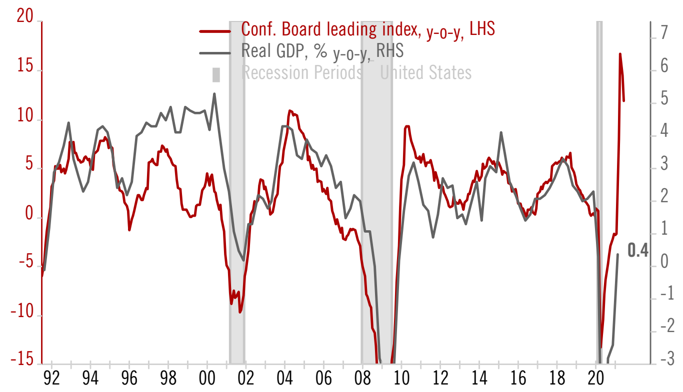
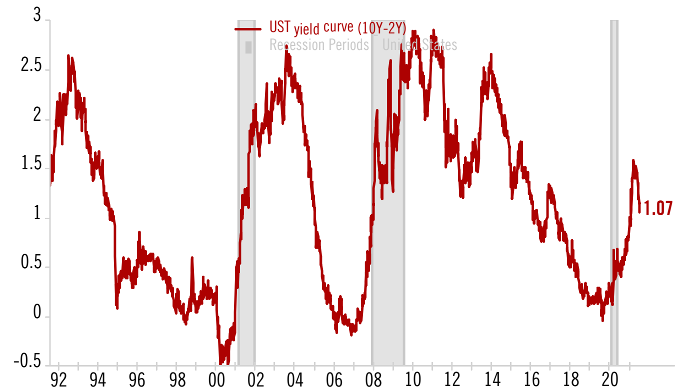
CONF. BOARD LEADING INDEX, % Y-O-Y VS GDP GROWTH, % Y-O-Y



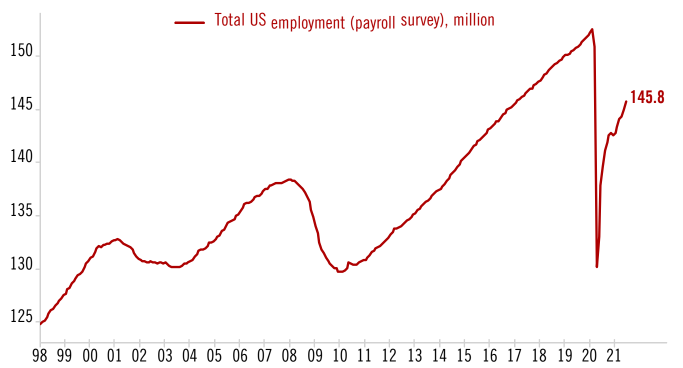
Source: PWM - AA&MR, Factset

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



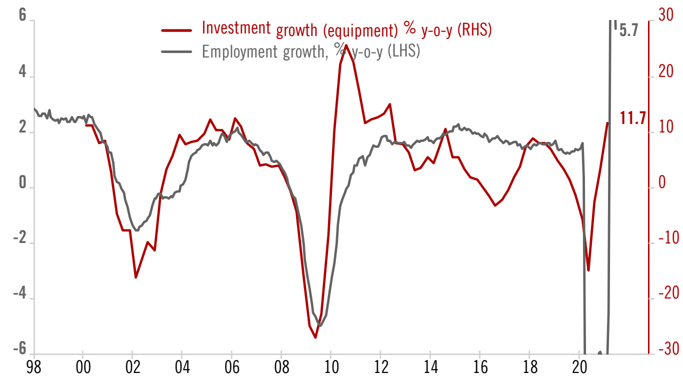
Source: PWM - AA&MR, Factset (last close)

TOTAL US EMPLOYMENT



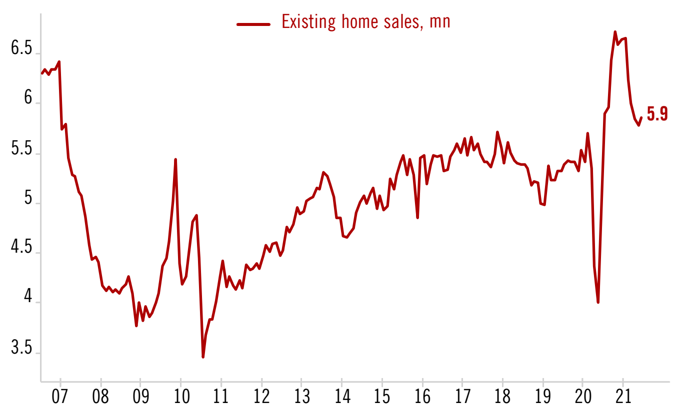
Source: PWM - AA&MR, Factset

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



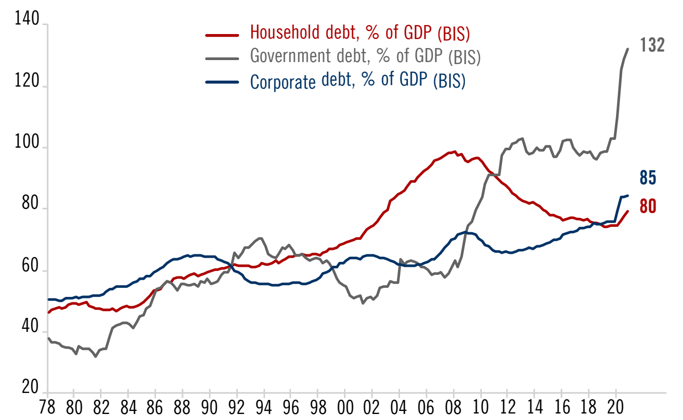
Source: PWM - AA&MR, Factset

EXISTING HOME SALES, MILLION UNITS (ANNUALISED)



Source: PWM - AA&MR, Factset

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



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