FLASH NOTE

PICTET WEALTH MANAGEMENT
ASSET ALLOCATION & MACRO RESEARCH
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FOMC MEETING PREVIEW - SEPTEMBER 2021

ANOTHER STEP TOWARD TAPERING

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SUMMARY

- The main message from the Federal Open Market Committee (FOMC) meeting on 22 September will likely be that the Fed will announce QE tapering at the following meeting, on 3 November.
- This would be in line with the well-telegraphed schedule; we think Chairman Powell, who is seeking re-nomination, is mostly in ‘do-no-harm’ mode for now.
- Some regional Fed presidents will express their more restive attitude through the updated ‘dot plot’. But the dot plot tends to exaggerate the importance of regional Fed presidents’ views over the more dovish Board of Governors in Washington DC: it should not be taken at face value for future policy direction.
- The new dot plot unveiled could show the median forecast for the first rate hike being brought forward to 2022 from 2023, as most regional Fed presidents are more worried about the inflation risk than Chairman Powell. Regional presidents have also become more uneasy about quantitative easing’s (QE) impact on housing prices and asset prices in general. They fear that the combination of zero rates and QE could nurture financial instability.
- Our central scenario is still that the Fed’s position on inflation means that the first interest-rate hike will only come in 2023, starting what we believe will be a very shallow rate-hiking cycle.
- The Federal Reserve is, in our view, worried that ‘true’ tightening of policy could destabilise a financial system characterised by high levels of private and public debt. We think the Fed will take its mission to achieve “maximum employment” literally (and more literally than “price stability”).
- The main risks to Powell’s very accommodative monetary-policy philosophy, which has strong echoes in the fashionable Modern Monetary Theory, is, first, that the labour market is already much tighter than he believes and, second, that inflation expectations become unanchored. While dismissed by Powell, inflation expectations of US economic agents are creeping up and deserve scrutiny.

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'First do no harm'

We think the 22 September FOMC meeting will provide further signs that a definite decision on the reduction of the Fed's monthly bond purchases ("taper") will come at the **following meeting on 3 November**. This would hardly be a surprise, as Chairman Jerome Powell has already signalled that taper would start before year's end.

Some might ask whether the slowdown in job creation in August (due to the spread of the Delta variant and uneven vaccination rates around the country) as well as choppy consumer survey data and global supply-chain issues (e.g., falling availability of cars), should not lead to a delay in the taper schedule. The market consensus for Q3 GDP fell to 5.0% q-o-q SAAR, from 7% in early August.

But the usual decision-making inertia within the Federal Reserve means that it would really need a sharp growth shock or a material tightening of financial conditions for it to change its plans. The official argument for dismissing recent uneven macroeconomic data and pressing ahead with starting tapering before year's end is likely to be that there has been **enough "cumulative progress"** in the recovery in recent months.

Of interest will be the extent to which some regional Fed presidents start to show their discontent with the very sluggish pace of monetary normalisation adopted by the 'core' members of the policy committee (Jerome Powell, Richard Clarida, John Williams). **One way regional Fed presidents might show their unease is by pushing forward their projections for future rate increases in a revised 'dot plot'**. The median projection for 2022 is likely to be for one rate hike, compared with none in the June dot plot. We also predict the dot plan will show that Fed officials expect three rate hikes in 2023 (compared with two in June). The dot plot could also show two additional rate hikes in 2024.

What else to keep in mind before the FOMC meeting? First of all, **Chairman Powell is seeking renomination** for another four-year term. As a result, he will probably seek to be as vague and inoffensive as possible (and therefore will not rush the QE taper schedule). **Powell is widely expected to be re-appointed, in large part because of his deft handling of the fallout from the pandemic**.

At the press conference, journalists could ask questions about the Fed's commitment to QE as a policy tool. A change in the Fed's stance regarding QE could have important implications for how the Fed responds to future economic shocks. As was evident even at the Jackson Hole central bank symposium this year, mainstream economists have lately become less convinced of the benefits of large QE in the current circumstances, or at least have been adopting a more nuanced view. Some are now subtly hinting that QE may exacerbate wealth inequalities and therefore depress the theoretical neutral rate that serves as a benchmark for monetary policy. QE's merits have also been tarnished by questions in the press about some FOMC members' stock trading in 2020, just as the Fed unleashed unprecedented liquidity into the financial markets.

From a big-picture perspective, **we do not think the approaching QE taper means a change in the underlying monetary regime**. The fundamental regime remains one of persistently easy policy. This regime dates back to Alan Greenspan, but was really accelerated by Ben Bernanke. It was further refined under the chairmanship of Janet Yellen and pressed even further by Jerome Powell. The latest example of this fundamental dovishness is the Fed's adoption in 2020 of a "flexible average inflation"

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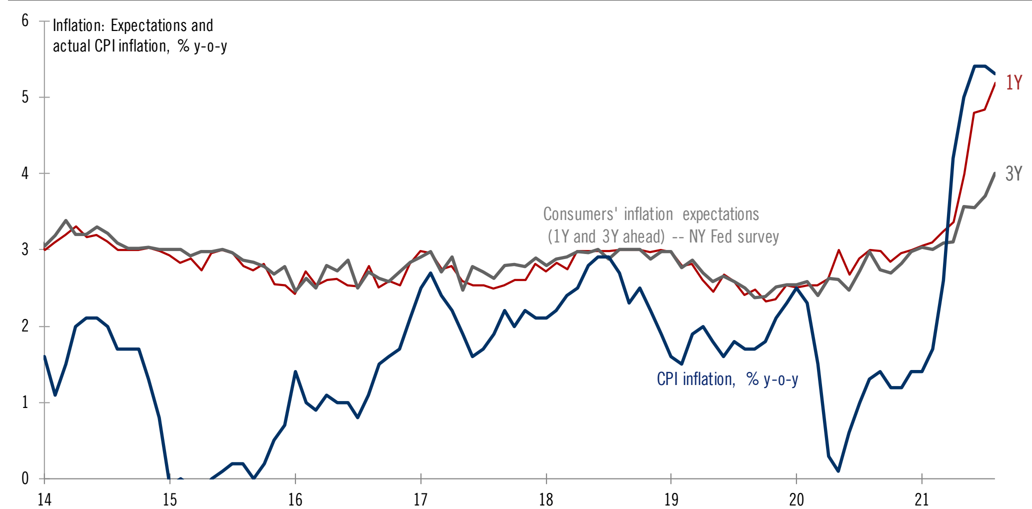
target. This represents something of a break with the Fed's traditional monetary stance dating back to the 1980s and 1990s (with implicit adherence to monetary policy "rules") but is in keeping with a deeply engrained **belief that deflation rather than inflation remains its main foe.**

Too many constraints to really 'tighten' US monetary policy

It is also a regime where explicit and implicit constraints on tightening monetary policy are enormous (by 'tightening' we mean bringing interest rates above the medium-term inflation rate). These constraints range from high government and private debt, the Fed's new implicit mission to foster social inclusion and, increasingly, climate-change considerations. Bottom line, **Fed interest rates are likely to stay low, potentially below the rate of inflation, for several years**. We continue to see the first rate hike in 2023, but think the Fed funds rate is likely to stay below 2% over the medium term.

Nonetheless, **unlike Chairman Jerome Powell, we think the main risk is an inflation spiral rather than a deflation spiral in the medium term**. We are not there yet, and we still see inflation as "temporary" (even though high inflation will persist next year)—but our confidence in that central scenario could be dented should we see wage growth rise above 5% (versus 3.9% 'median' y-o-y wage growth in August) together with a further rise in consumers' inflation expectations. **In an extreme scenario, a big step-up in inflation expectations could suddenly trigger a "Volcker moment" that sees the Fed sharply tightening policy to break the inflation spiral. Once again, we are not there yet but it is an important risk**.

CHART 1: US CONSUMERS' INFLATION EXPECTATIONS ARE CREEPING UP



Source: Pictet WM-AA&MR, Bloomberg, 16 September 2021.

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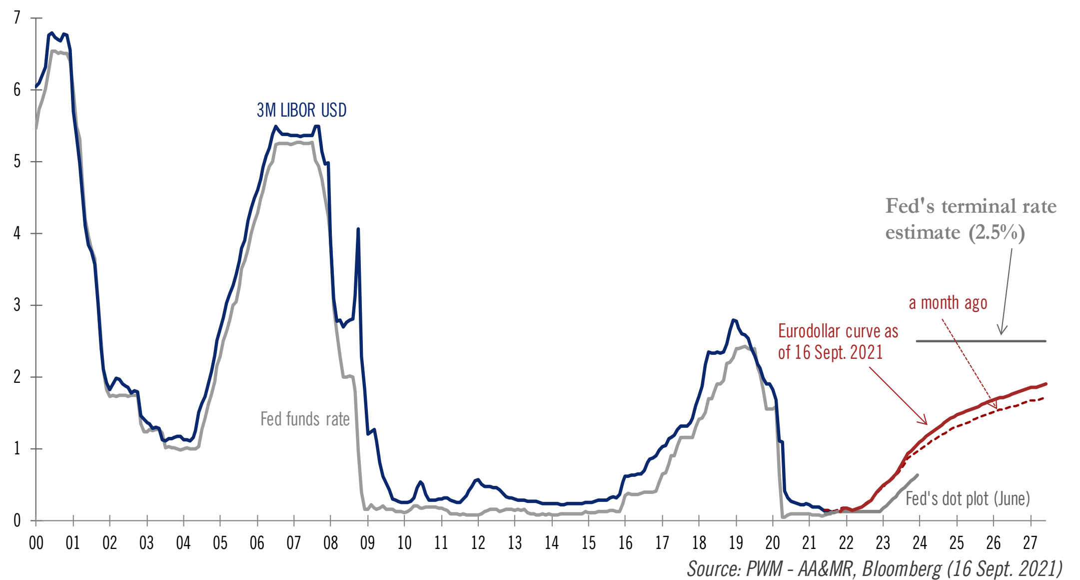
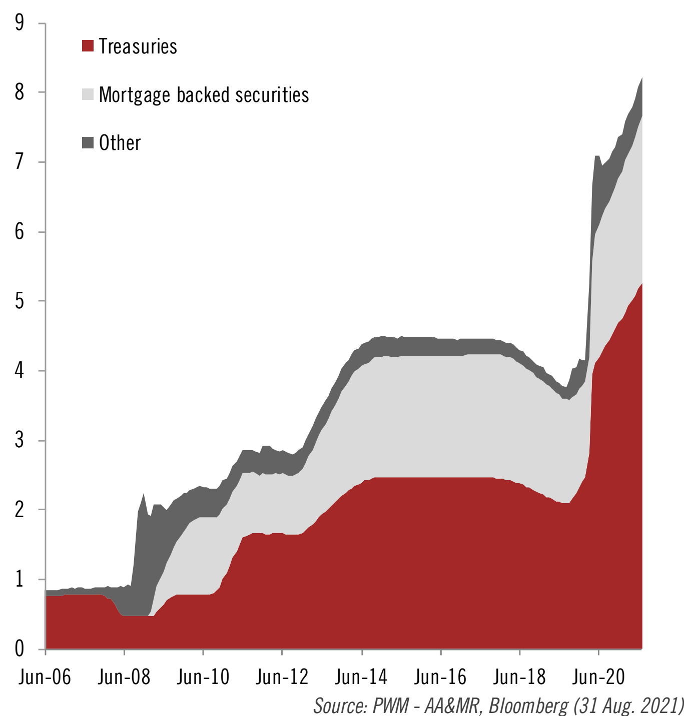
FED FUNDS RATE, 3M LIBOR AND EURODOLLAR FUTURES CURVE



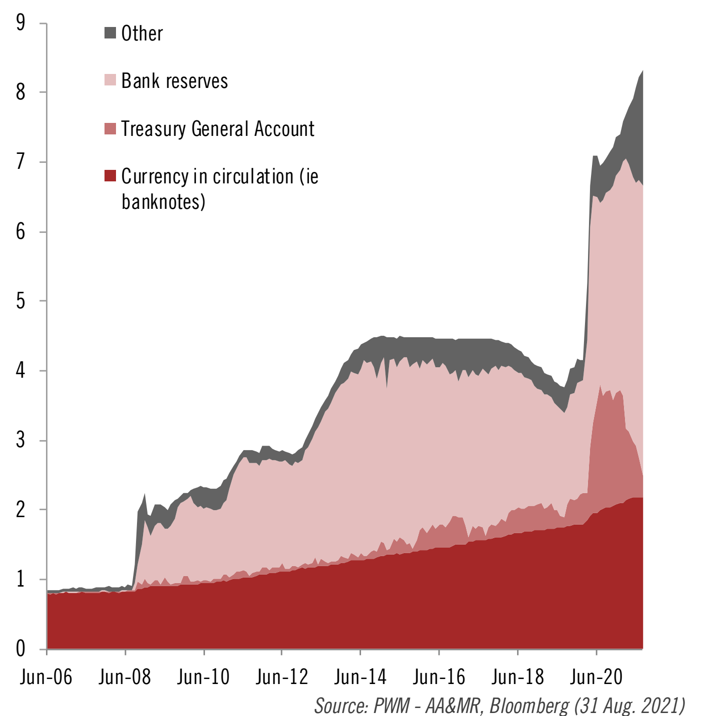
Source: PWM - AA&MR, Bloomberg (16 Sept. 2021)

FED ASSETS (USD TRILLION)



Source: PWM - AA&MR, Bloomberg (31 Aug. 2021)

FED LIABILITIES (USD TRILLION)



Source: PWM - AA&MR, Bloomberg (31 Aug. 2021)

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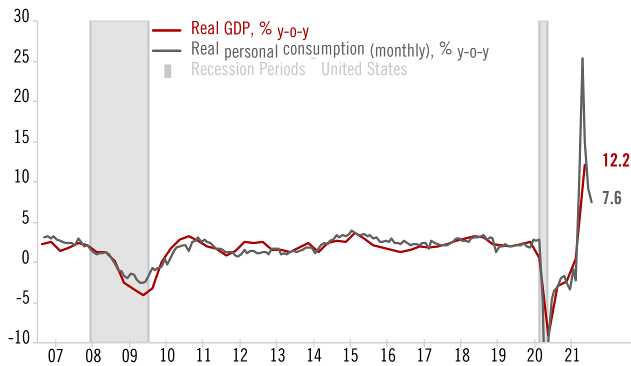
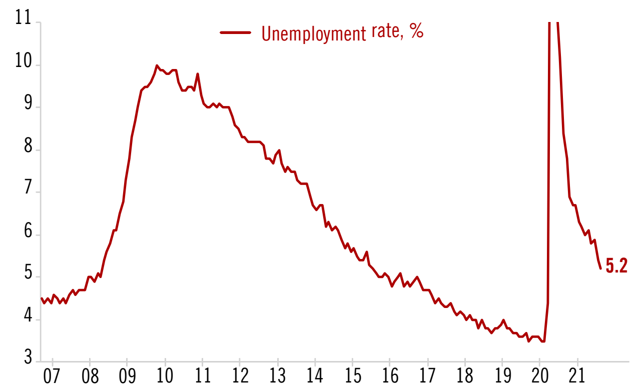
REAL GDP AND PRIVATE CONSUMPTION GROWTH, % Y-O-Y



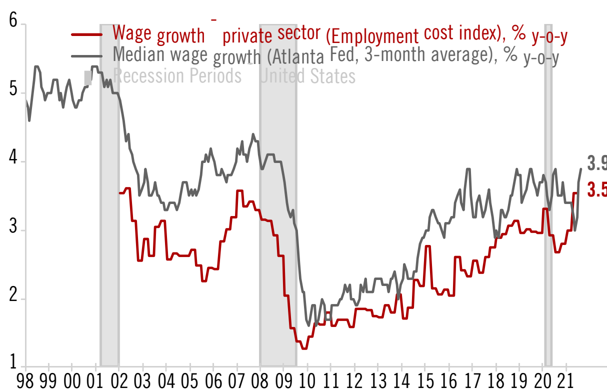
Source: Pictet WM – AA&MR, Factset

UNEMPLOYMENT RATE, %



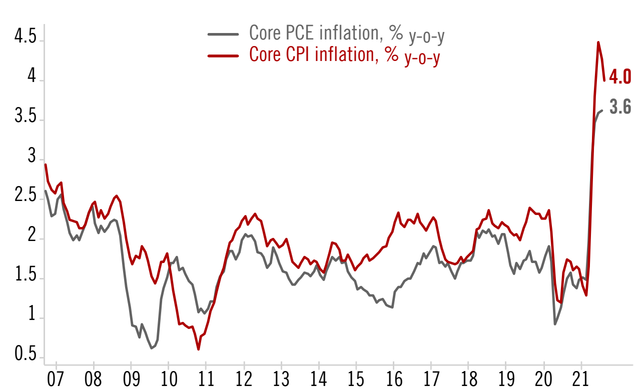
Source: Pictet WM – AA&MR, Factset

WAGE GROWTH INDICATORS, % Y-O-Y



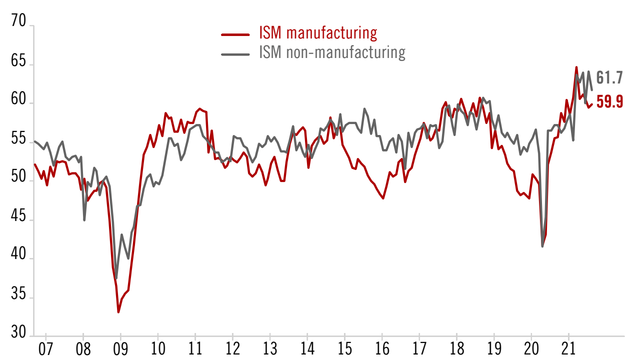
Source: Pictet WM – AA&MR, Factset

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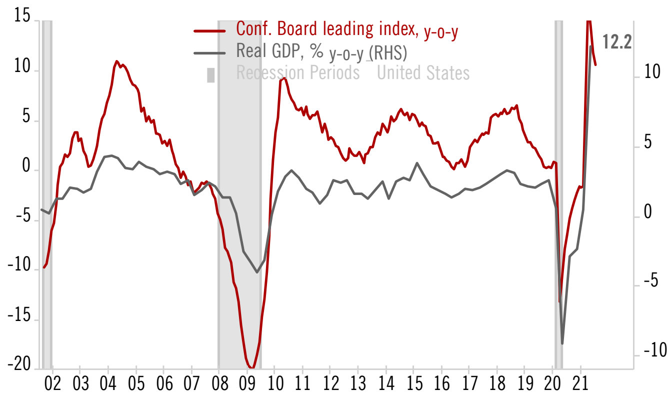
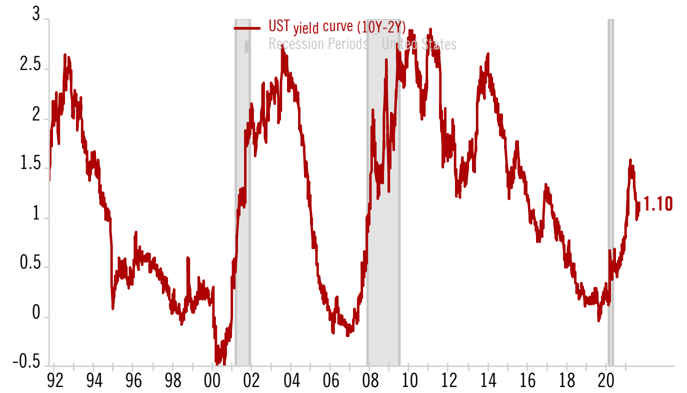
CONF. BOARD LEADING INDEX, % Y-O-Y VS GDP GROWTH, % Y-O-Y



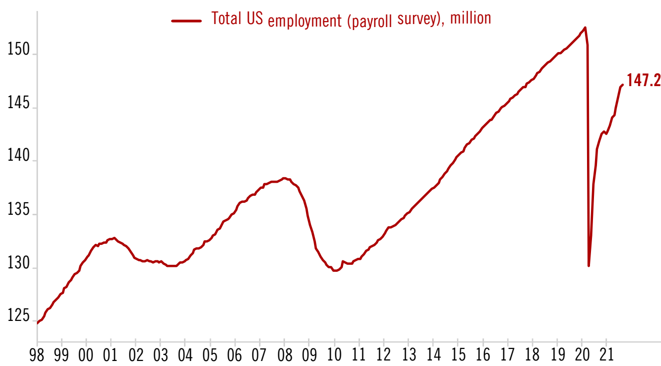
Source: PWM - AA&MR, Factset

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



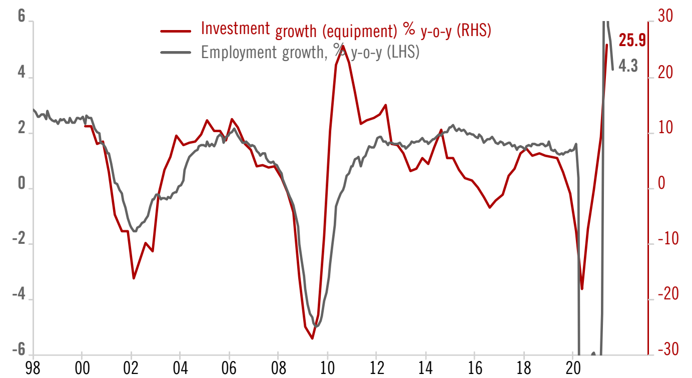
Source: PWM - AA&MR, Factset (last close)

TOTAL US EMPLOYMENT



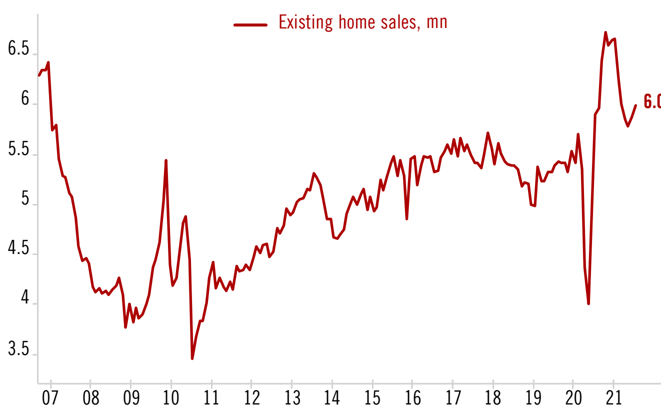
Source: PWM - AA&MR, Factset

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



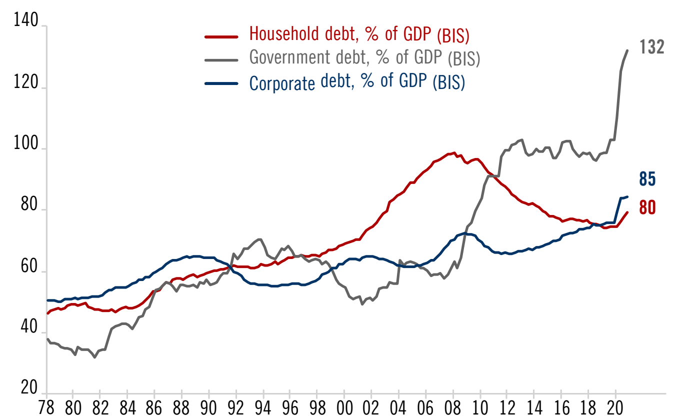
Source: PWM - AA&MR, Factset

EXISTING HOME SALES, MILLION UNITS (ANNUALISED)



Source: PWM - AA&MR, Factset

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



Source: PWM - AA&MR, Factset

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