# FOMC Minutes Spark Slight Treasury Short Covering

- **Treasuries rally, USD dips on FOMC minutes…**
- **…as market participants looking for early taper clues had to cover…**
- **…because FOMC participants did not appeal to such a rush**
- **We still expect tapering by Dec/Jan and rate hikes starting early 2023 with earlier risk**

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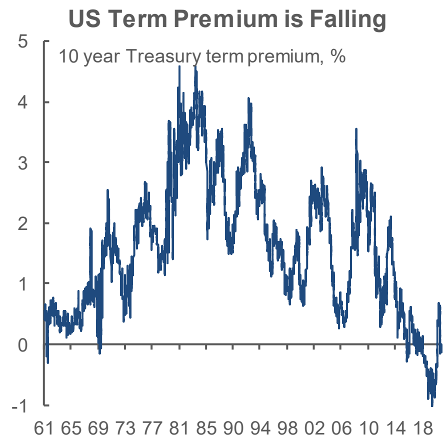
Ten year Treasury yields fell by about 2bps but are still marginally up on the day and the USD depreciated a touch in the wake of the release of minutes to the July 27th–28th FOMC meeting. The portion of the market that was positioned for a signal that the committee is moving toward an early taper had to cover their short positions in Ts. That portion could not have been very large given the relatively small market movements.

Overall I see nothing here to inform a view contrary to our current expectations that the Fed announces a first taper in December, implements in January and hikes by early 2023 with earlier risk. Also there is nothing here to suggest they'd be in a rush to shut down purchases along an aggressive timeline such as by Q1 or next summer and so the messaging leans toward moving later and going slower than some may prefer. It's still the case they want more evidence/data and they *may* wish to ride out the Delta wave and debt ceiling for a while yet.

This messaging may also further downplay the significance of the Fed's Jackson Hole symposium next Thursday through Saturday. I can't think that Chair Powell is going to stand up a week from Friday and shift toward embracing imminent tapering. That probably makes JH rather less interesting especially given it's going to be more domestically oriented in terms of participants than usual given the in-person aspect during the pandemic. To this point, we already know that ECB President Lagarde and BoE Governor Bailey will not be in attendance. Indeed, it's kind of hard to think how it would be responsible of global central bankers to be traipsing through airports, hopping in cars, going through a resort hotel and meeting in person with Delta variant cases rising including in Wyoming.

A staff presentation on the merits of large-scale asset purchases preceded the discussion by FOMC participants. Staff repeated that the main effect was to reduce the private sector's holdings of longer-term assets and thereby attach a premium to their prices and reduce the term premium. The Treasury term premium has indeed collapsed back to where it was in the 1960s (chart 1). It had risen up to March of this year but has since declined again. Staff also noted the risk that changes in purchases could be interpreted by markets as a signal that fed funds rate hikes lie around the corner.

Chart 1




Sources: Scotiabank Economics, New York Federal Reserve.

The money maker quote from the minutes was the following one (with emphasis added):

> "Most participants judged that the Committee's standard of "substantial further progress" toward the maximum-employment goal ***had not yet been met***. At the same time, most participants remarked that this standard had been achieved with respect to the price-stability goal. A few

participants noted, however, that the transitory nature of this year's rise in inflation, as well as the recent declines in longer-term yields and in market-based measures of inflation compensation, cast doubt on the degree of progress that had been made toward the price-stability goal since December."

Appetite for reducing purchases sooner, such as at the September FOMC meeting, remains a minority opinion as the quote below informs. That means there is little support for reducing purchases sooner beyond St. Louis Fed President Bullard (nonvoting 2021, voting 2022), Boston Fed President Rosengren (nonvoting 2021, voting 2022), KC President George (nonvoting 2021, voting 2022) and Dallas President Kaplan (nonvoting 2021, nonvoting 2022, voting 2023). It's fairly typical for regional Presidents to strike out on their own at turning points ahead of the top of the house that often stays circumspect for longer and lags behind.

> "***Some*** participants suggested that it would be prudent for the Committee to prepare for starting to reduce its pace of asset purchases relatively soon, in light of the risk that the recent high inflation readings could prove to be more persistent than they had anticipated and because an earlier start to reducing asset purchases would most likely enable additions to securities holdings to be concluded before the Committee judged it appropriate to raise the federal funds rate."

Still, committee participants remain generally on track for tapering sometime later this year as evidenced by the following quotes:

> "Most participants noted that, provided that the economy were to evolve broadly as they anticipated, they judged that it could be appropriate to start reducing the pace of asset purchases this year because they saw the Committee's "substantial further progress" criterion as satisfied with respect to the price-stability goal and as close to being satisfied with respect to the maximum employment goal."

> "Various participants commented that economic and financial conditions would likely warrant a reduction in coming months."

Still, not everyone agreed as an offset to the aforementioned more hawkish tail of opinion on the FOMC:

> "Several others indicated, however, that a reduction in the pace of asset purchases was more likely to become appropriate early next year because they saw prevailing conditions in the labor market as not being close to meeting the Committee's "substantial further progress" standard or because of uncertainty about the degree of progress toward the price-stability goal."

Minority participants were divided on the merits of tapering soon:

> "A few participants expressed concerns that maintaining highly accommodative financial conditions might contribute to a further buildup in risk to the financial system that could impede the attainment of the Committee's dual-mandate goals."

versus

> "In contrast, a few other participants suggested that preparations for reducing the pace of asset purchases should encompass the possibility that the reductions might not occur for some time and highlighted the risks that rising COVID-19 cases associated with the spread of the Delta variant could cause delays in returning to work and school and so damp the economic recovery."

And

> "Several participants also remained concerned about the mediumterm outlook for inflation and the possibility of the reemergence of significant downward pressure on inflation, especially in light of the recent decline in longerterm inflation compensation."

And

> "In addition, several participants emphasized that there was considerable uncertainty about the likely resolution of the labor market shortages and supply bottlenecks and about the influence of pandemic-related developments on longer-run labor market and inflation dynamics. Those participants stressed that the Committee should be patient in assessing progress toward its goals and in announcing changes to its plans on asset purchases."

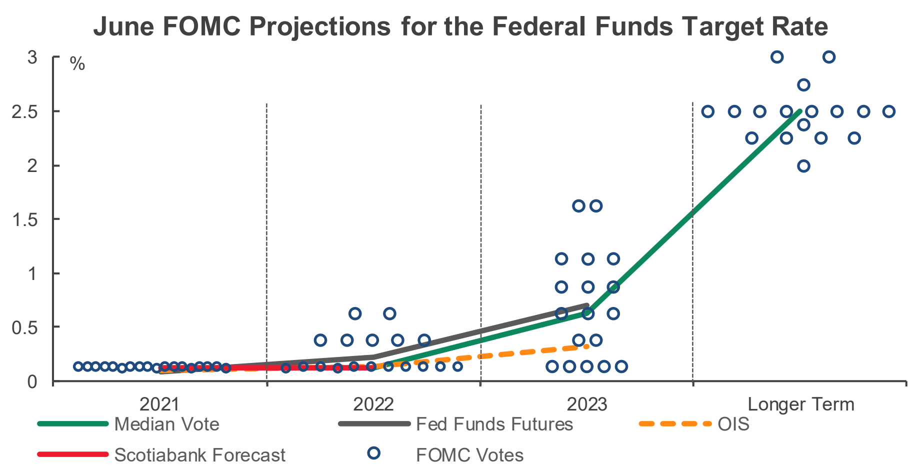
On timing operations beyond the initial taper, the Committee had this to say:

> "Many participants noted that, when a reduction in the pace of asset purchases became appropriate, it would be important that the Committee clearly reaffirm the absence of any mechanical link between the timing of tapering and that of an eventual increase in the target range for the federal funds rate."

> "Several participants emphasized that an announcement of a reduction in the Committee's pace of asset purchases should not be interpreted as the beginning of a predetermined course for raising the federal funds rate from its current level."

On this point, however, we're left with the potential conflict between what the Committee is expressing through the dot plot of future rate movements versus the absence of a mechanical timing link between tapering and hiking. Recall that the June dots (chart 2) showed that 7 FOMC participants want hikes starting in 2022. 13 of 18 want them by 2023 with only five holds. Nothing mechanical? Kind of looks as if there is in the dots if tapering starts around the end of 2021, probably takes all or most of 2022 to fully wind down purchases and then hikes begin according to the FOMC's central tendency opinion. The next round of updated projections will be offered at the September 21st–22nd meeting.

Chart 2




Note: OIS & Fed Fund Futures as of June 16th, 2021.
Sources: Scotiabank Economics, US Federal Reserve.