

The FOMC Adds To Exit Guidance

- Tapering is likely to commence in November...
- ...with purchases ending mid-2022
- The FOMC forecasts more hikes...
- ...while being divided on whether to start in 2022...
- ...with 2023 still the base case
- Forecast changes were focused upon higher inflation
- Additional press conference insights

The FOMC tweaked guidance in a few areas but on net they were either relatively minor changes and/or so far out in time as to be met by a 'show me' degree of skepticism in markets. Markets are also keenly watching matters surrounding the US debt ceiling and China's Evergrande and in a way that may involve taking Fed commitments on tapering and hikes with a grain of salt. The sum total of the moves broadly met Scotiabank Economics' expectations.

The S&P500 closed flat compared to just before the full suite of communications from the Fed, the USD slightly strengthened and the Treasury curve slightly flattened with a marginal rise in the two year and five year yields and a marginal decline in the 10 year yield.

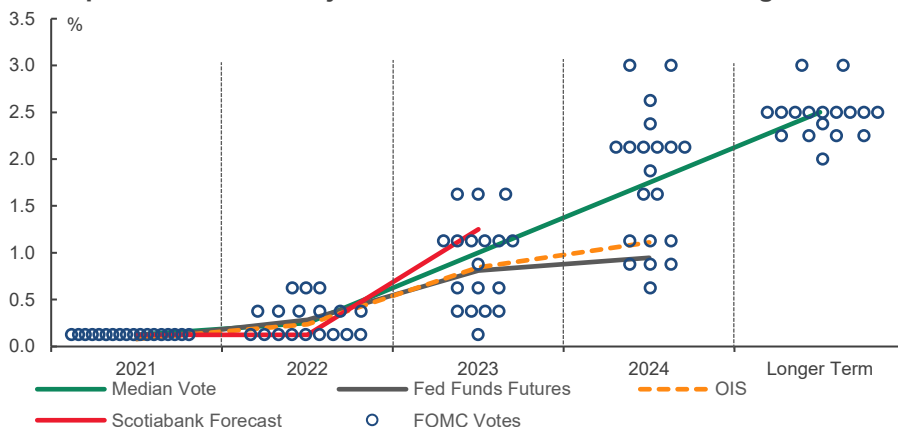
That's a perfectly sensible and very mild market outcome in relation to the overall set of changes and remarks that were offered.

A Summary of What the FOMC Did

The FOMC unanimously set up a probable November taper, guided that purchases would likely end by the middle of next year, played with the dot plot to

Chart 1

September FOMC Projections for the Federal Funds Target Rate

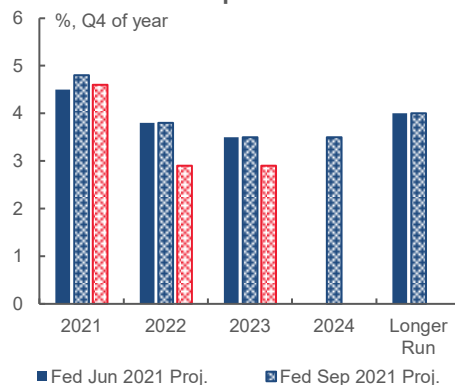


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Chart 2

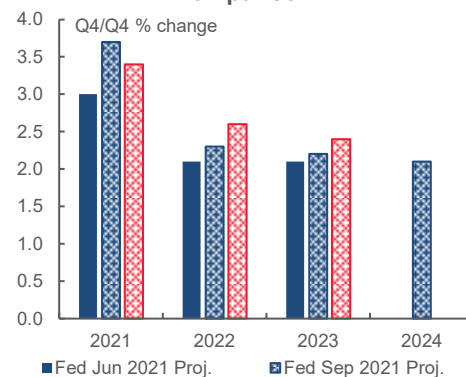
US Unemployment Rate Forecast Comparison



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Sept 22, 2021).

Chart 3

US Core PCE Inflation Forecast Comparison



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Sept 22, 2021).

show a split toward whether to hike or not next year and added to rate hikes thereafter at a pace that roughly equates to about one quarter-point hike per calendar quarter. They also tweaked forecasts by somewhat adding to their inflation expectations and punting growth from this year into next. Elaborations upon each of these moves follows and then additional considerations that were drawn from the press conference are highlighted afterward.

1. When to Start Tapering

The FOMC conditionally set up a reduction of Treasury and MBS purchases at the November 2nd–3rd meeting barring a big negative surprise in the one and only payrolls report before their next decision and assuming nothing else goes off the rails.

They did so by referencing that “a moderation in the pace of asset purchases may soon be warranted.” The word “soon” is the Fed’s code language for signalling something imminent.

2. How Fast to Taper

Chair Powell said in the press conference that the plan is to complete the wind down from US\$120 billion per month of Treasury (\$80B) and MBS (\$40B) purchases to net zero by “around the middle of next year.” That is in keeping with our expectations.

Powell said that no decision was made on the pace of reductions. He also did not remark on the composition of purchase reductions and specifically whether or not to reduce Treasury and MBS purchases in proportional terms or favouring one or the other. It’s likely they’ll do so in proportional terms, but the Chair did not broach the topic today.

3. Hike guidance

The committee was divided on whether to hike in 2022 but I sense Powell is sceptical toward a 2022 lift-off. They upped the 2023 hikes a bit and added 3 hikes in 2024 to get to 1.8% 3+ years from now, but few take the dot plot literally anyway given its performance. They left the UR forecasts unchanged and slightly increased core PCE forecasts in 2022–23 while extending above-2% to 2024 (2.1%).

Statement Changes

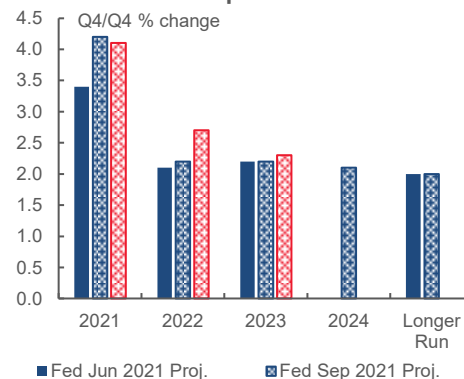
There were very few statement changes that are flagged in the appendix to this note. They included the following that bolster the observations provided above.

- The biggest is in the fourth paragraph that states a taper “may soon be warranted” while dropping references to “coming meetings” that when combined together suggest that a November taper is in the cards barring a notable disappointment over the next six weeks. That same paragraph struck out reference to “continue to assess progress” and replaced it with the lower standard that conditions a taper around “If progress continues broadly as expected.”
- The second paragraph offered minor changes, the biggest of which was to replace inflation “has risen” with “is elevated” which implies a touch more discomfort toward present levels rather than just saying they’ve risen.

Revised Dots

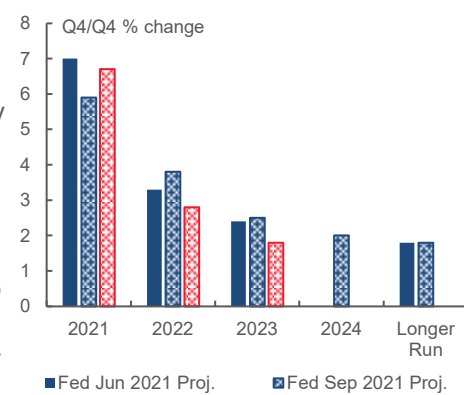
Chart 1 on the front page shows the latest Rorschach plot from the FOMC. 2022 went from 11–7 in favour of a hold with 5 calling for one hike and 2 expecting 2 hikes, to now showing 9 expecting a continued hold and 9 expecting a hike with six expecting one hike and 3 expecting two hikes. The median estimate is on the bubble between a hike and no hike next year. Key remains vote-weighting this outcome and note that the composition of the FOMC shifts toward being incrementally more hawkish next year.

Chart 4
US PCE Inflation Forecast Comparison



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Sept 22, 2021).

Chart 5
US Real GDP Forecast Comparison



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Sept 22, 2021).

2023 saw a bit more of a shift with two more hikes than previously and toward a 1% rate by year-end.

2024 showed for the first time three more hikes to a 1¾% policy rate.

The long-run neutral rate estimate of 2.5% was left unchanged.

Stepping back from some of the surprises, it's worth noting that even by 2024 the median dot is still saying they'll only be at the bottom of the estimated neutral rate range 3+ years from now, ending at 1.75% with 6 hikes total.

Forecast Revisions

Charts 2–5 show the forecast revisions to GDP growth, the unemployment rate and inflation rates. Summary observations follow.

1. GDP

Growth projections were lowered for this year in a mark-to-market sense like everyone else given recently mixed readings (5.9% from 7%). 2022 was revised up to 3.8% (from 3.3%) and so the bias is to punt this year's downward revision into next year. 2023 was little changed at 2.5% (from 2.4%) and the addition of 2024 sees the FOMC consensus at 2% with an unchanged longer run proxy for potential growth unchanged at 1.8%.

2. Inflation

Core PCE inflation was revised up by 0.7% to 3.7% this year largely in mark-to-market fashion given that the FOMC previously underestimated inflationary pressures to date. They went further, however, by revising up 2022 by two ticks to 2.3% and by revising up 2023 a tick to 2.2% with the addition of the 2024 forecast expecting another above 2% reading of 2.1%.

Headline inflation was revised up 0.8 points to 4.2% this year but also revised up a tick to 2.2% in 2022 with 2023 left unchanged at 2.2% and then the addition of 2024 set at 2.1%.

When commenting on the forecast revisions, Powell noted that the FOMC moved up its nearer terms forecast due to bottlenecks and shortages and how they have not yet begun to abate and could be with us into next year.

3. Unemployment

The unemployment rate was revised up a bit for this year to 4.8% from 4.5%, but left unchanged for 2022 (3.8%) and 2023 (3.5%) while the addition of 2024 sees the rate flat at 3.5%. The longer run unemployment rate remains unchanged at 4%.

Additional Press Conference Insights

Beyond the statement and forecasts, Powell's press conference offered the following insights.

A High Bar to be Knocked Off Taper Plans

When asked whether he still expects solid jobs reports going forward and whether a soft September report would affect prospects for tapering as soon as the November meeting, Powell said **"it would not take a knock-out jobs report to meet the test, only a reasonably good report."** Powell went on to dismiss the August payrolls weakness as a Delta report while indicating that he still expects faster job growth when parents return to work as the kids go back to school. That's unclear, however, in that the Household Pulse survey shows that most parents already went back to work over the summer during the months when about one-million per month gains were being clocked. If so, then September payrolls could still reflect the Delta drag and be absent the parental effect that might have largely concluded earlier.

An Inclusive Recovery and Monetary Policy

Powell has backpedaled on the extent to which the Fed will focus upon a fully inclusive recovery compared to earlier in the pandemic. When asked point blank "Would a sustained black versus aggregate unemployment rate gap alter your plans, Powell said that eliminating racial and other disparities is best left to fiscal and education policies and that "We've done our part." That's sensible to monetary policy observers who understand the limits of the Fed's powers to affect individual groups in society relative to other policy tools, but it's a striking difference to Powell's earlier remarks on the need to have a fully inclusive recovery before seeking policy exits.

Ducked the Debt Ceiling

Powell was asked what he thinks of the debt ceiling uncertainties and simply gave a throwaway comment on how “it’s very important to pay our bills and address the debt ceiling.” When probed for what he tells members of Congress and other officials, Powell deflated by saying “I don’t discuss conversations I have with elected officials.”

Evergrande’s Effects

Powell was asked two questions regarding China’s issues with Evergrande. The first question was whether it was a preview of the risks facing US corporate debt given the level of US corporate debt. Powell shot that down by noting US corporate defaults are very low and that while they were concerned at the beginning of the pandemic due to the revenue hit, they did not ultimately get a wave of corporate defaults partly due to the CARES Act.

The second question regarding Evergrande pertained to how the Fed views its implications. Powell argued that it seems very particular to China which has very high debt for an EM economy and Evergrande is part of getting that under control. He noted that there is little direct US exposure and that big Chinese banks have little exposure. In general, Powell’s tone indicated he is not so fussed by it all. One hopes he’s right, but near-term events will rapidly inform this perspective.

What Happens After Tapering

Powell was asked about his thoughts on shrinking the balance sheet and deflected the question by saying “let’s taper first and then get to those other related issues. We’ll do that but first things first.”

Earlier Rate Hikes?

When asked whether lift-off on rates could occur before finishing tapering, Powell said “That’s not my expectation,” and went on to note that they could instead speed up or slow down taper plans. He also observed that back in 2013–14 they said tapering is not on a pre-set course and yet “This will likely be a shorter period than in 2013 because the economy is much further along than back then.” The implication is that rather than hiking ahead of ending purchases, the Fed would be more likely to speed up tapering first and should conditions warrant such a step.

Digital Currencies

On digital currencies, Powell advised that the Fed is looking at whether to introduce a central bank digital currency (CBDC) and evaluating the pros and cons. He noted there will soon be a discussion paper to inform the Fed’s stance on a CBDC. He noted that they need to ensure that appropriate regulatory conditions are in place and that they are not.

Please see the attached tracking of changes in the September policy statement compared to the July statement.

FOMC Statement Changes: September 22nd versus July 28th

The Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals.

With progress on vaccinations and strong policy support, indicators of economic activity and employment have continued to strengthen. The sectors most adversely affected by the pandemic have ~~shown improvement~~ improved in recent months, but ~~have not fully recovered~~. the rise in COVID-19 cases has slowed their recovery. Inflation has ~~risen~~ is elevated, largely reflecting transitory factors. Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.

The path of the economy continues to depend on the course of the virus. Progress on vaccinations will likely continue to reduce the effects of the public health crisis on the economy, but risks to the economic outlook remain.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With inflation having run persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved. The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. Last December, the Committee indicated that it would continue to increase its holdings of Treasury securities by at least \$80 billion per month and of agency mortgage-backed securities by at least \$40 billion per month until substantial further progress has been made toward its maximum employment and price stability goals. Since then, the economy has made progress toward these goals, and if progress continues broadly as expected, the Committee ~~will continue to assess progress~~ judges that a moderation in coming meetings the pace of asset purchases may soon be warranted. These asset purchases help foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Thomas I. Barkin; Raphael W. Bostic; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Mary C. Daly; Charles L. Evans; Randal K. Quarles; and Christopher J. Waller.

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