The FOMC Took Another Successful Step

- **Communications largely met expectations…**
- **...while avoiding feared outcomes**
- **Tapering and rate hikes were brought forward**
- **Powell more fully explained his pivot**
- **The meeting minutes may further inform key questions**

The Federal Reserve successfully took a further step toward the exits and without significantly disrupting financial markets. In fact, stocks rallied, Treasuries hardly budged, and the USD depreciated largely out of relief that a more abruptly hawkish pivot was not pursued. Yet. For now, the Fed gets high marks for advance communication around a hawkish pivot that was reasonably well telegraphed. A lot has been learned since the 2013 taper tantrum.

WHAT CHANGED

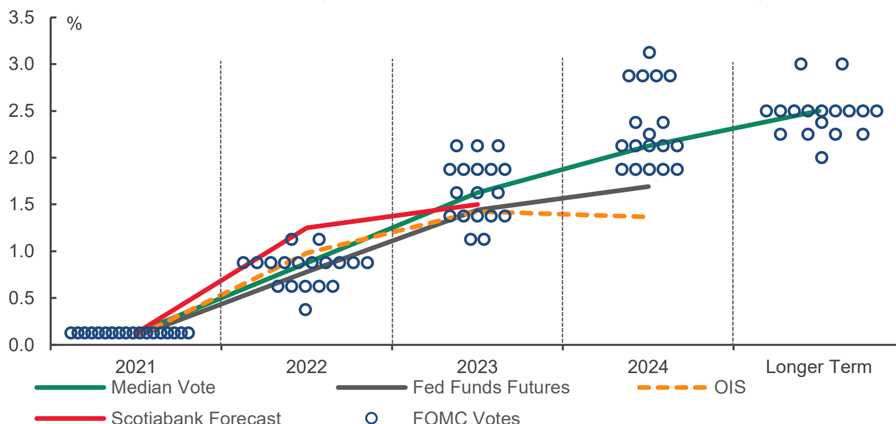
What they did can be summed up in five main points derived from the statement (here), the Summary of Economic Projections (here) and the press conference. Please also see the attached statement comparison.

1. Rate hikes pulled forward

Chart 1 shows the updated dot plot in relation to our forecast and both fed funds futures and OIS pricing.

The median FOMC projection calls for 75bps of hikes in 2022 and then another identical move in 2023. The end result would be to still wind up below most estimates of the neutral policy rate two years from now. That implies that the Fed would still be applying a marginal amount of stimulus to an economy well past the point of needing it. I suspect they'll coax markets along a tighter path over time and that the dots are one part about economics and reflective of present uncertainties, and the other about managing markets. Still, the fact that there were

Chart 1



Note: OIS & Fed Fund Futures as of Sept 22nd, 2021.
Sources: Scotiabank Economics, US Federal Reserve.

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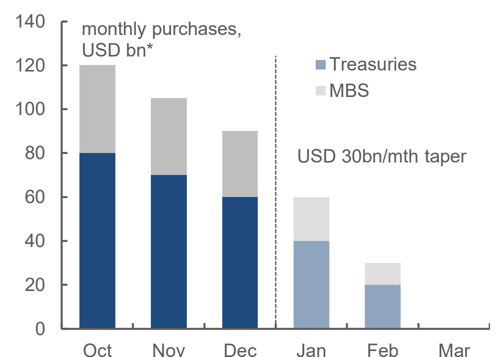
Chart 2



*Expected announcement for purchases over the following month. Ex. Feb. announcement of mid-March conclusion of purchases.
Sources: Scotiabank Economics.

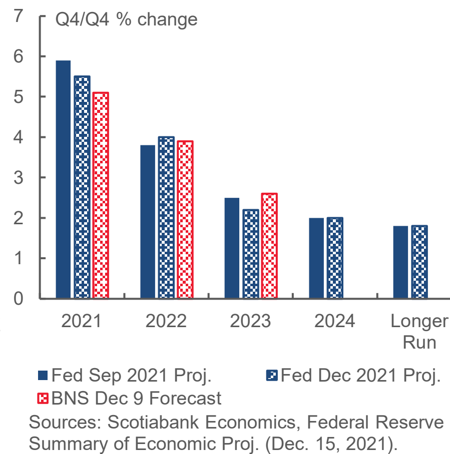
only two FOMC members who were willing to signal more than 3 hikes and that even they only went one above helped to assuage some market fears around the pace at which Powell and Co would run screaming toward the exits.

Markets might have also been relieved if they inferred that the committee wants a bit of distance from ending purchases in March and subsequently hiking. Three hikes in 2022 and the distribution of meetings over 2022 could inform this view. I think the first hike is most likely to be delivered at a full meeting with full communications which could mean March, but then if they go as soon as March then they're signalling only two hikes over the remaining 6 meetings which doesn't signal much conviction to tighten every third meeting on balance. Our forecast for lift-off is June and for 100bps of hikes over 2022.

Powell noted that the FOMC still intends to maintain an unchanged fed funds rate range until maximum employment is achieved and that all FOMC members expect this to happen next year. Powell did note, however, that "In my view we are making rapid progress toward maximum employment."

Chart 3

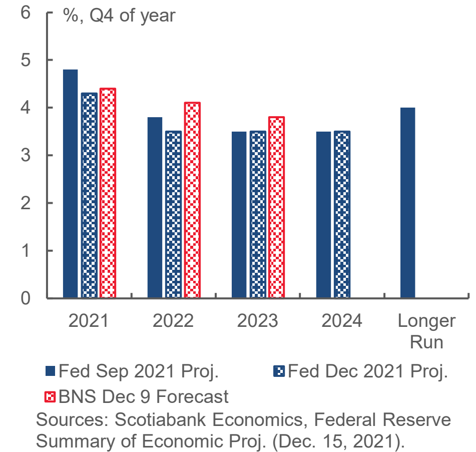
US Real GDP Forecast Comparison



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Dec. 15, 2021).

Chart 4

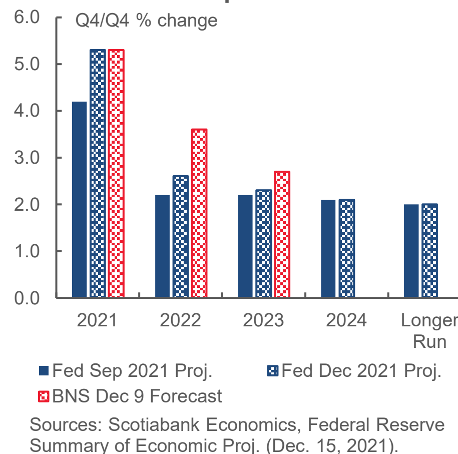
US Unemployment Rate Forecast Comparison



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Dec. 15, 2021).

Chart 5

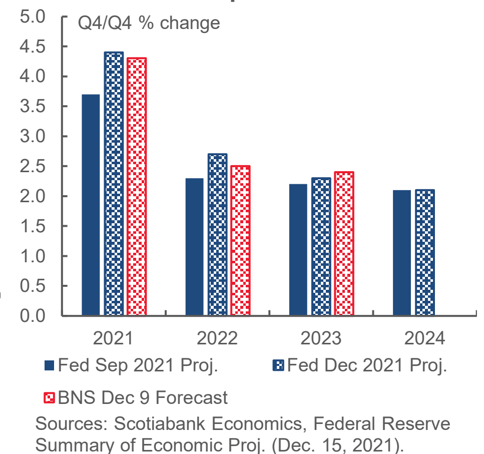
US PCE Inflation Forecast Comparison



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Dec. 15, 2021).

Chart 6

US Core PCE Inflation Forecast Comparison



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Dec. 15, 2021).

2. Earlier end to bond purchases

Big surprise here! Not. Everyone—probably even the pizza delivery guy—expected the FOMC to expedite tapering by the amounts and pace described in the statement and as shown in chart 2. Another US$30 billion reduction in monthly Treasury and MBS purchases is planned for implementation in January and "similar reductions in the pace of net asset purchases will likely be appropriate each month." There are only so many months before that path gets to zero. By March, in fact.

One motivation for ending purchases earlier was confirmed when Chair Powell stated that "a quicker conclusion of our purchases will give us more flexibility to consider the full range of outcomes" and policy choices.

3. Open guidance on other balance sheet plans

Before purchases end in March, the FOMC will have to make some other key decisions on balance sheet management.

When asked about how much distance he thinks there may be between ending purchases and hiking and what to do in between and after the first hike, the short answer involved guidance to wait for the minutes in three weeks time and specifically watch for language that cites the frequency of opinion (eg. "some", "a few," "many," "most," etc.) around whether to pursue a period of reinvestment and for how long before hiking and for how long after how many hikes. Powell simply said they discussed balance sheet issues but haven't made any decisions of that nature. He indicated that the committee discussed differences compared to the 2013–15 experience and stated "I don't foresee us taking that long a period of time after ending purchases before hiking." That wasn't terribly useful to markets since markets are priced for lift off by June and hence much sooner than after ending purchases in 2014.

4. Transitory?? Pfft. Who said that anyway?!!

There were material changes to the statement language around inflation that confirms the Powell-led FOMC has done a full pivot.

First, the November 3rd statement had said “Inflation is elevated, largely reflecting factors that are expected to be transitory.” That’s gone. You won’t find the word anywhere in the December statement.

Second, the statement now struck out “With inflation having run persistently below this longer-run goal” and replaced it with “With inflation having exceeded 2 percent for some time….”

Third, the language around current inflation was refreshed to “elevated levels of inflation” instead of “sizable price increases in some sectors.”

5. Forecasts: Lower Unemployment and More Inflation

Charts 3–6 show the updated FOMC forecasts for growth, inflation and the unemployment rate. GDP growth was lowered a bit this year given year-to-date tracking, upped a touch in 2022, lowered a bit in 2023 and left unchanged beyond that. Strong growth is forecast for next year and growth in 2023–24 is forecast to be a little above the economy’s noninflationary speed limit.

The unemployment rate projections were revised down for this year by a half point given stronger job markets, lowered again for 2022 partly given this better starting point plus assumed additional progress, and then left unchanged thereafter.

PCE and core PCE inflation were revised up this year given year-to-date tracking. Both were also revised up next year which is consistent with firmer growth but also Chair Powell’s view that supply side challenges will persist “well into next year.” A touch more inflation was also added into 2023 before it returns toward target thereafter. Powell’s opening remarks to his press conference noted that “price increases have now spread to a greater numbers of goods and services" but wage growth isn't very hot so far but is being monitored.

RELATED DISCUSSIONS

There were a number of other areas of discussion during the press conference that further informed the Powell pivot.

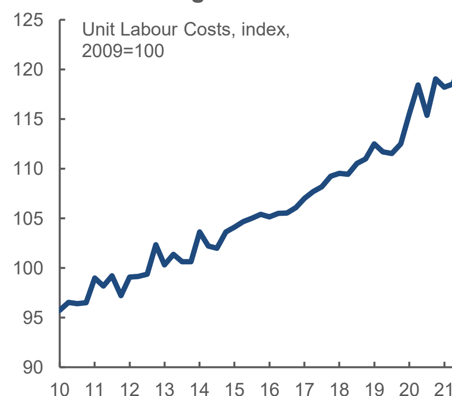
Maximum Employment and Wages

This is where I thought Powell’s communications were somewhat confusing and somewhat revisionist in nature. During the press conference, he noted that real wage gains are not in excess of productivity growth and are therefore not inflationary. He’s likely reference average hourly wages minus inflation relative to trend productivity.

He also went on to note, however, that the spike in the Employment Cost Index on the eve of the November FOMC meeting was among the short list of factors that motivated him to change his mind on inflation. ECI captures wages and benefits. Yet unit labour costs are an all-in-one measure of employment costs relative to real GDP with the latter embodying productivity. ULCs are accelerating faster during the pandemic than before which doesn’t seem to support the narrative that employment costs are not more inflationary than previously (chart 7).

Chart 7

US Wage Inflation Has Accelerated During the Pandemic



Sources: Scotiabank Economics, Bloomberg.

The other cited factors were the strong jobs report and the strong CPI report. Powell said “I honestly at that point really decided we needed to speed up the taper.”

Perhaps, but there will always be doubts around whether the Fed Chair just simply fouled up on ‘transitory’ inflation—which I think he did—and whether his candidacy for a second term as Fed Chair clouded his thinking.

Still, when probed about why he thinks progress toward maximum employment is faster, Powell’s main point was that “the disappointing metric has been labour force participation. I thought last Fall that we would see a significant surge in labour force participation due to vaccinations and return to school and lower job supports etc. It seems now that the return to the labour force will take longer which is what has happened in past cycles.”

Also note that gone was any reference toward more inclusive measures of progress in labour markets compared to the strong amount of emphasis Powell put on them in earlier press conferences.

Omicron worries?

The statement noted that "risks to the outlook remain, including from new variants of the virus" which leaves open the possibility we may see additional variants. Powell said "I think there's a lot of uncertainty which is why we put it as a risk in our statement." He went on, however, to note that "The early evidence is that omicron is highly transmissable, but less severe. But what will be the effect on the economy depends upon how it operates on demand and also supply and hence the impact on inflation is uncertain. This is going on at the same time as a wave of Delta cases. I do think wave upon wave people are learning to live with it, and more people are getting vaccinated."

Powell nevertheless noted that "notwithstanding this the committee participants continue to foresee rapid growth."

One reason for this is that both the statement and Chair Powell's comments expect two influences to cross one another: they expect supply constraints to ease up as an offset to omicron worries. The statement spelled it out by noting "progress on vaccinations and an easing of supply constraints are expected to support continued gains in economic activity and employment as well as a reduction in inflation."

He did sensibly note that the Summary of Economic Projections put out by the FOMC is not a plan, it is an expectation for policy that is based upon their forecasts. The median forecast expects strong growth and strong inflation. If the economy turns out to be quite different from that then Powell said "of course we'd change our actual rate decisions that depend upon the evolving nature of the forecast." This matches our philosophy. Forecast with the best reasonably know information at a point of time and then monitor.

Still, at the end of the day, Powell says that he thinks the economy can handle putting away bond purchases no matter what omicron brings.

Is the Fed Behind the Curve?

Powell's belief is that the lags between changes in monetary policy signals, the impact upon financial conditions and the linkages to the economy and inflation may be shorter than others may assume. This was offered as a defence against why he shouldn't get out of bond purchases and onto hikes even faster if taking his time were to mean a slower response to inflationary pressures. Powell's argument was that "we think markets can be sensitive to it and we've always preferred a methodical approach. I do think that in this connected world, financial conditions can affect economies shorter than 6 months. In addition, when we communicate changes, financial conditions can react immediately. They don't wait to change, they change when they expect changes."

In my personal view, he's right on financial conditions reacting rapidly and in anticipation, but I didn't like his implied tone on how long it takes for such changes to impact the economy and inflation.

Does the Treasury Curve Worry Powell?

When asked if he's worried about the bond market signals and specifically if he would prefer a steeper curve before hiking Powell's answer wasn't very compelling. He noted "A lot of things go into long rates. Around the world they are so much lower elsewhere. It's not surprising to have so much demand for Treasuries relative to bunds and JGBs. There may also be some assessment of the neutral rate embedded in the Treasury market. We'll make decisions based on what we think is appropriate for the economy. I'm not troubled by where the long bond is."

The debate is around whether a relatively flat curve is a bond market warning sign against hiking too much too fast, or whether the curve is distorted. Time will tell. It could be too flat because of another over-reaction to omicron just as Ts rallied into the summer/Fall wave. One could also argue that earlier debt ceiling and funding uncertainty pushed yields temporarily lower. As supply gets taken down in markets with the dwindled amount in Treasury's General Account and as the Fed shuts down bond purchases we could wind up facing a very different bond market into 2022.

As a final point, there remains work to be done in controlling Fed releases. The communications began to arrive just before the 2pmET window. There may not have been equal monitoring across market participants which would connote an advantage to some.

RELEASE DATE: December 15, 2021

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 improved in recent months ***but continue to be affected by COVID-19***. ***Job gains have been solid in recent months, and the unemployment rate has declined substantially. Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation.*** 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 and an easing of supply constraints are expected to support continued gains in economic activity and employment as well as a reduction in inflation. ***Risks to the economic outlook remain, including from new variants of the virus.***

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent. ***With inflation having exceeded 2 percent for some time, the Committee 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.*** In light of inflation developments and the further improvement in the labor market, the Committee decided to reduce the monthly pace of its net asset purchases by $20 billion for Treasury securities and $10 billion for agency mortgage-backed securities. ***Beginning in January, the Committee will increase its holdings of Treasury securities by at least $40 billion per month and of agency mortgage‐backed securities by at least $20 billion per month. The Committee judges that similar reductions in the pace of net asset purchases will likely be appropriate each month, but it is prepared to adjust the pace of purchases if warranted by changes in the economic outlook.*** The Federal Reserve's ongoing purchases and holdings of securities will continue to 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.

RELEASE DATE: November 3, 2021

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 improved in recent months, ***but the summer's rise in COVID-19 cases has slowed their recovery***. ***Inflation is elevated, largely reflecting factors that are expected to be transitory. Supply and demand imbalances related to the pandemic and the reopening of the economy have contributed to sizable price increases in some sectors.*** 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 and an easing of supply constraints are expected to support continued gains in economic activity and employment as well as a reduction in inflation. ***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. In light of the substantial further progress the economy has made toward the Committee's goals since last December, the Committee decided to begin reducing the monthly pace of its net asset purchases by $10 billion for Treasury securities and $5 billion for agency mortgage-backed securities. Beginning later this month, the Committee will increase its holdings of Treasury securities by at least $70 billion per month and of agency mortgage-backed securities by at least $35 billion per month. Beginning in December, the Committee will increase its holdings of Treasury securities by at least $60 billion per month and of agency mortgage-backed securities by at least $30 billion per month. The Committee judges that similar reductions in the pace of net asset purchases will likely be appropriate each month, but it is prepared to adjust the pace of purchases if warranted by changes in the economic outlook. The Federal Reserve's ongoing purchases and holdings of securities will continue to foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

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