

Fed gives notice that tapering could soon begin

The September FOMC meeting of the US Federal Reserve concluded as expected with no changes to monetary policy. The central bank kept the funds rate in its target range of 0.00-0.25% as well as continuing to implement an open-ended asset purchase programme. There was unanimity within the Federal Open Market Committee (FOMC) to leave interest rates unchanged.

The big issue for the Fed to consider at this meeting revolved around when to start tapering its large scale QE asset purchase programme. The minutes from its last meeting in July showed there was a wide ranging discussion on scaling back QE, but there were divergent views on the issue. Fed Chair Powell in a major speech at end August hinted that tapering might commence before the end of the year.

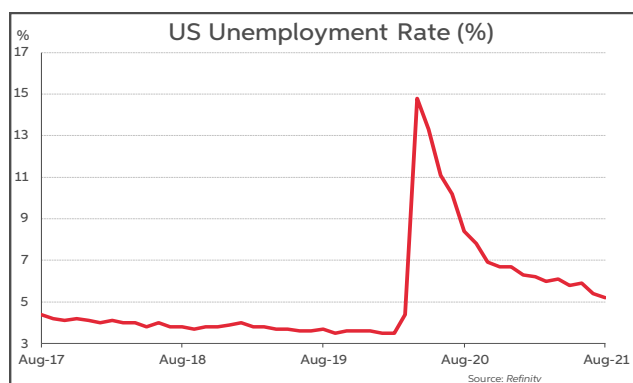
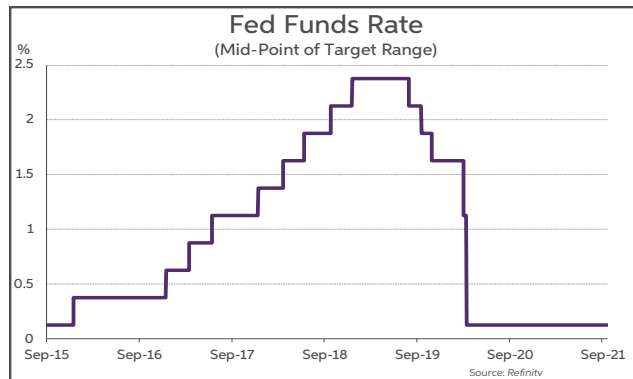
The Fed Chair give more clarity on this at his post meeting press conference. He stated that if the recovery in the economy continues broadly as expected, then a decision on tapering could come as soon as the next policy meeting at the beginning of November. Furthermore, he indicated that a gradual tapering process that concludes around the middle of next year is likely to be appropriate. Asset purchases under the Fed's QE programme are running at \$120bn per month, suggesting that they could be scaled back by \$15bn per month over an eight month period, starting in either November or December.

The Fed Chair was keen to emphasise that the threshold for raising rates was more stringent than reducing bond purchases. Nevertheless, the Fed continues to turn more hawkish on the rate outlook. In terms of its latest interest rate projections, the September update represented a further hardening of its 'dot plot' versus June, when it shifted towards an earlier tightening of rate policy. Now half or 9 of the 18 FOMC members are of the view that a rate hike will be required in 2022, compared to 7 in June. Meanwhile, for 2023, all but one FOMC member now expects that rate hikes will be warranted. In June, 5 FOMC members anticipated rates remaining unchanged through to the end of 2023.

The median projection is for a small 12.5bps hike to 0.25% in 2022, while the FOMC now sees rates rising to 1% by end 2023 compared to 0.625% at the June meeting. The Fed also provided forecasts for 2024 for the first time, with the median projection for rates to rise by a further 75bps to 1.75%. These new forecasts mean the Fed has turned more hawkish than the market on rates. Futures contracts also look for just a small rise of 0.125% in the funds rate to 0.25% around the end of 2022. However, markets then look for rates to rise by a circa further 50bps the following year, taking the funds rate to 0.75% by end 2023, with rates expected to be hiked by another 50bps to 1.25% by end 2024.

The Fed also released its updated view on the economic outlook. This saw a downward revisions to its 2021 growth projection, with the Delta variant slowing the pace of recovery since mid-year. Meanwhile, there were upward adjustments to its inflation forecasts. On the growth front, the Fed lowered its Q4 2021 GDP growth forecast appreciably to 5.9% y/y (versus previous forecast of 7% y/y). However, it increased its growth projection for end 2022 to 3.8% y/y (from 3.3% in June), with end 2023 little changed at 2.5% y/y. Meantime, it now expects core-PCE inflation to rise to 3.8% (was 3.3%) by the end of this year, declining back to 2.3% (was 2.1%) by the end of 2022 and 2.2% (was 2.1%) by end-2023. Forecasts were provided for 2024 for the first time, with end year growth and inflation projected at 2.0% and 2.1%, respectively. Thus, the Fed sees inflation remaining slightly above target in three years time.

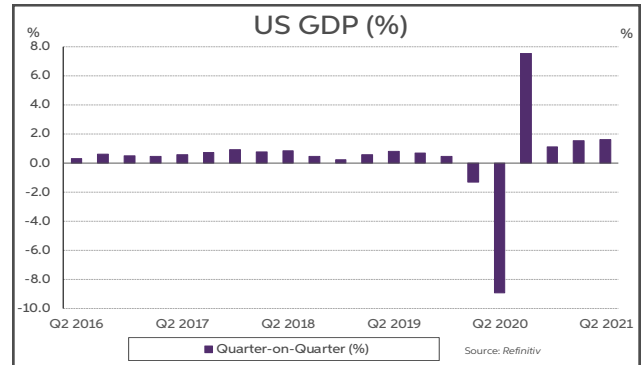
The market reaction was limited given that tapering was widely expected to commence later this year. Meanwhile, the projected steeper rate hikes are still quite some time away and the Fed Chair highlighted that the threshold for hikes was more stringent than reducing asset purchases. Still, the muted reaction was surprising.



US economy experiencing growing pains

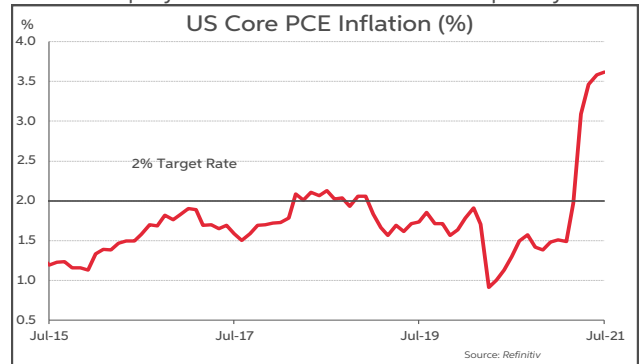
The US economy grew by an annualised growth rate of 6.6% in Q2. This follows a 6.3% expansion in Q1 as economic activity regained momentum buoyed by the rapid pace of the vaccine rollout and substantial fiscal stimulus. In terms of the underlying breakdown in Q2, the expansion was led by a 11.9% annualised rise in consumer spending, which added 7.8 percentage points (p.p.) to GDP. Government spending fell by 1.9%, largely due to a decline in non-defence expenditure, clipping output by 0.3 p.p.. Investment contributed a further 0.6 p.p., although, a run down in inventories subtracted 1.3 p.p from growth. Meanwhile net trade subtracted 0.2 p.p from the total.

However, hard data suggest that US growth may have peaked at the end of Q2. Retail sales for example, fell by 1.8% in July and rebounded by a modest 0.7% in August. It should be noted that this means retail sales are still 17.4% above their pre-pandemic level. In terms of industrial production, output regained its pre-Covid level in August also. There are signs though that the pace of growth in production is easing. In the three months to August, output expanded by circa 5% in annualised terms, compared to 7-9% in previous months.



Survey data is also consistent with the economy growing at a slower pace in the third quarter than it was earlier in the year. The services PMI for example, averaged 66.6 in Q2 as the economy re-opened in full, but it has since declined to 56.5 in Q3. The manufacturing PMI averaged 61.7 in Q3, only slightly below its 61.9 average in Q2, but it has been edging lower in recent months also. Firms in both sectors report issues with supply chains and difficulties in finding workers as constraints on activity. Meanwhile, consumer confidence has plunged in the third quarter due to a surge in Covid cases, and concerns regarding the rapid rise in inflation. The Conference Board measure fell to 113.8 in August from its peak of 128.9 in June. The Michigan measure shows an even greater fall in consumer sentiment, and is currently below its level in April of last year, its post-Covid trough.

In terms of the labour market, jobs growth slowed markedly in August. Payrolls expanded by just 235k in the month, as the pace of hiring in Covid-sensitive sectors stalled. Employment in the leisure and hospitality sector was unchanged in August, having grown by circa 350k per month in the previous six months. Nonetheless, the jobless rate continues to trend lower and was at 5.2% in August. However, this masks the shortfall in employment, as labour force participation remains relatively low due to fears of contracting Covid and increased caretaking of children and the elderly. The Fed expects these factors to diminish over the remainder of the year though, and payrolls are likely to grow more rapidly in the months ahead as enhanced federal unemployment benefits have now ended.



Meanwhile, inflation remains elevated and is likely to stay so in the months ahead. Core-PCE inflation reached 3.6% in June and remained at that level in July as base effects, and supply constraints contributed to higher prices. Similarly, CPI inflation remains elevated at 5.3% in August, having hit 5.4% in June. However, despite inflation proving stronger than the Fed had anticipated, the central bank still expects it to prove transitory in the years ahead, with the Q4 core-PCE rate falling from 3.7% this year, to 2.3% in 2022 and 2.2% in 2023.

It is clear from the data, that the recovery in the US economy is bringing challenges. Growth has slowed since mid-year due to the spread of the Delta Covid variant. The jobs market recovery will take some time, and inflation may well remain elevated for longer than anticipated given the issues around supply. Meanwhile, longer-term it remains to be seen whether another large infrastructure spending bill can be pushed through Congress, as had been outlined earlier in the year. Potential increases to the US corporate tax rate may act as a headwind to investment also. The OECD is now projecting growth of 6.0% for this year and 3.9% in 2022. The updated forecasts from the Fed today are broadly similar, with growth slowing to 2.5% by end 2023 and 2% by end 2024.

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