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INVESTMENT TALKS

16 December 2021

14-15 December FOMC review: pressing the gas on taper

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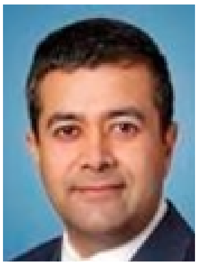

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- ***FOMC statement****: The tone of the Federal Open Market Committee (FOMC) statement was hawkish, with a focus on higher inflation risks and more aggressive policy tightening. There were notable changes to the statement: the Fed retired the word 'transitory' to describe inflation; the Fed pointed to the recent inflation developments that directly led to a speeding up of tapering; the Fed announced that it would double the pace of tapering of its net asset purchases. The monthly reduction in such purchases will be $20bn for Treasury securities and $10bn for agency mortgage-backed securities (MBS) in January, up from the earlier monthly pace of $10bn for Treasury and $5bn for agency MBS. This pace is likely to end the Fed's asset purchase programme by mid-March.*
- ***Economic projections and rate expectations:*** *The Fed is projecting the economy to expand 5.5% in 2021 and 4.0% in 2022. They offered sharp upward revisions to Core PCE projection for 2021 (from 3.7% in September to 4.4%) and for 2022 (from 2.3% to 2.7%). There was also a sharp downward revision to the 2021 unemployment rate forecast, from 4.8% to 4.3% over the past quarter. The Fed members offered dramatic changes to the Federal Funds rate projection, with the median year-end 2022 rate moving from 0.125% to 0.875%, the median year-end 2023 rate moving up 0.75% to 1.625%, and the median year-end 2024 rate moving up 0.50% to 2.125%. In 2024, the median projection stands at 2.00-2.25%, just below the Fed's terminal rate of 2.50%. There were five 'Dots' that came in higher than the terminal rate (longer-run projection). The Fed's concern on inflation was the prominent theme of the press conference. Chair Powell raised the possibility of an earlier start to quantitative tightening. He emphasised that the economic and inflation circumstances are much different now compared to the last cycle.*
- ***Market reaction and investment implications****: The outcome of the FOMC meeting was more hawkish than expected. Market reaction was muted for fixed income, while it was positive on equities despite the hawkish Fed tone. The equity market reaction exemplifies the trust in the Fed's ability to master inflation while not hurting economic growth. While two-year Treasury yields have priced in fully the FOMC's projected pace of rate hikes, intermediate- and longer-term Treasury yields have not. We see risk of a bearish steepening of the yield curve. This reinforces our negative view on duration and is generally positive for value equities relative to growth equities. Despite the Fed's shift to reducing accommodative monetary policy, policy will remain accommodative in 2022, as the Fed Funds rate was forecasted to be well below the 'neutral' rate. Such easy financial conditions will be supportive of risk assets. Solid consumer fundamentals should support the broader consumption as well as housing markets, which underpins our positive view on securitised credit investments.*

In the final, and highly anticipated, FOMC meeting of 2021, the Committee delivered a more hawkish than expected message, with a focus on higher inflation risks and more aggressive monetary policy tightening. The financial markets reaction, which rallied broadly, reflected a different interpretation, for now.

FOMC statement: speeding up of tapering

The tone of the FOMC statement was hawkish, as the Fed's concern on inflation has become evident. There were three notable changes to the statement and some minor adjustments:

- **The Fed retired the word 'transitory' to describe inflation**. We believe this is a belated recognition that inflation will remain higher for longer than they had expected. In fact, the Fed highlighted that "*supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation*".

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"The Fed is likely to end its asset purchase programme by mid-March."

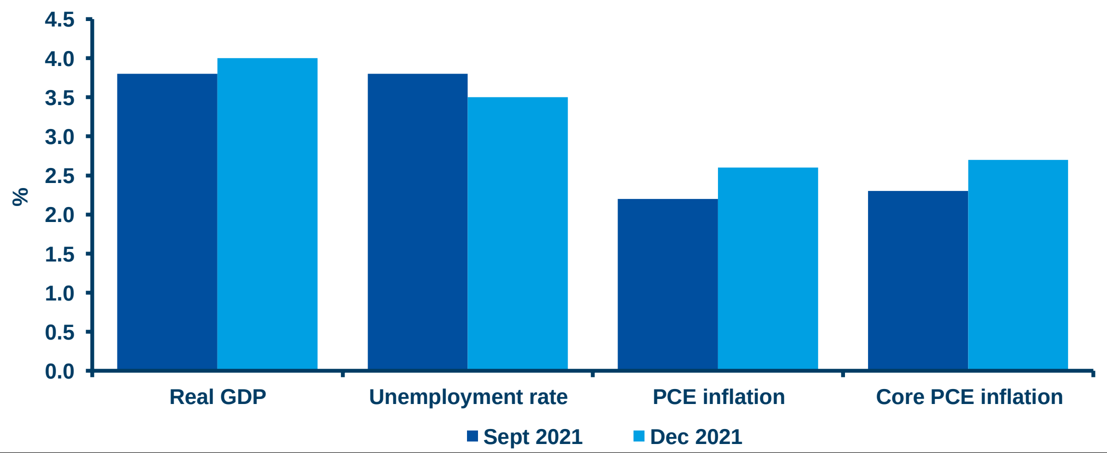
- **The Fed pointed to the recent inflation developments that directly led to an acceleration of the asset purchase tapering process**. The Fed announced that it would double the pace of reducing the monthly pace it its asset purchases in January by $20bn for Treasury securities and $10bn for MBS, up from the earlier monthly pace of $10bn for Treasury and $5bn for agency MBS. **This pace is likely to end the Fed's asset purchase programme by mid-March.**
- **The improvement in the labour market also played a role in accelerating** the taper and will take on a more prominent role in the monetary policy actions going forward.

Elsewhere, there was an upgrade in the Fed's description of the US economy, as it described the sectors most adversely affected by the pandemic as having improved in recent months. Finally, the Fed flagged appropriately potential economic outlook risks stemming from new virus variants.

SEP and the 'Dots': sharp jump in 'Dots' reflects rise in inflation forecasts

The Summary of Economic Projections (SEP) reflected above trend growth, more persistent inflation, and a labour market on the path to reach the Fed's 'maximum employment' criteria in 2022. The Fed projected the economy to expand 5.5% in 2021 and 4.0% in 2022. They offered a sharp upward revision to Core PCE for 2021 (from 3.7% to 4.4%) and for 2022 (from 2.25% to 2.75%) when compared to September SEP forecasts. We note that the 2022 Core PCE expectation of 2.75% was above market consensus forecast of 2.5%. There was also a sharp downward revision to the 2021 unemployment rate forecast, from 4.8% to 4.3% over the past quarter. The Fed members offered dramatic changes to the Federal Funds rate projection, with the median year-end 2022 rate moving from 0.125% to 0.875%, the median year-end 2023 rate moving up 0.75% to 1.625%, and the median year-end 2024 rate moving up 0.50% to 2.125%. In other words, the 'Dots' now forecast three 25-bp rate hikes in 2022, three hikes in 2023, and two hikes in 2024. In fact, in 2024, the median projection stands at 2.00-2.25%, just below the Fed's terminal rate of 2.50%. There were five 'Dots' that came in higher than the terminal rate (longer-run projection).

Economic projections of FOMC members for 2022



Source: Amundi, Federal Reserve. Data is as of 16 December 2021.

"Chair Jerome Powell stated his concern about recent inflation developments. Factors including the strong employment cost index, a buoyant non-farm payroll report, and the stronger than expected November CPI data led him to conclude they need to speed the taper."

Press Conference: Powell strikes a hawkish tone

The Fed's concern on inflation was the prominent theme of the press conference. Chair Jerome Powell stated his concern about recent inflation developments. He referenced specifically the strong employment cost index, recent non-farm payrolls, and stronger than expected November CPI data as factors that led him to conclude they needed to speed the tapering process. He mentioned that an early end to the asset purchase programme gives the Fed optionality to move sooner on rates if the need arises. Chair Powell spent considerable time talking about the potential risks to inflation, such as if wage growth exceeds productivity growth though he does not believe this is an issue now. He mentioned that the Fed is focused on the sensitivity of owner's equivalent rent (OER) to a robust economy. He was very confident that the labour market is close to nearing maximum employment. He no longer expects a quick recovery in the labour force participation and de-emphasised it in their assessment of maximum employment. Interestingly, **Chair Powell raised the possibility of an earlier start to quantitative tightening (QT),** where the Fed's balance sheet is allowed to shrink as a certain amount of maturing securities are not reinvested. At multiple times during the press conference, he emphasised that the economic and inflation circumstances (i.e., much stronger) are much different now compared to the last cycle. If utilised, QT could steepen the yield curve, giving the FOMC more space to raise rates as needed to control inflation.

Market reaction and investment implications

The outcome of the FOMC meeting was more hawkish than we had expected, reflecting risks towards higher inflation and more aggressive monetary tightening. The reaction in the US Treasury market was reasonable and to be expected. Two- and five-year yields rose 1bp, while ten- and thirty-year yields rose 3bp, leading to a slight steepening of the yield curve. Contrary to expectations, equity markets rallied sharply between 1 to 2%. The dollar was broadly weaker against G10 and EM currencies.

"We see risk of a bearish steepening of the yield curve. This reinforces our negative view on duration and is positive for value stocks."

While two-year Treasury yields have fully priced in the FOMC's projected pace of rate hikes, intermediate- and longer-term Treasury yields have not**. We see risk of a bearish steepening of the yield curve**. **This reinforces our negative view on duration and is generally positive for value equities relative to growth equities**. **Despite the Fed's shift to reducing accommodative monetary policy, policy will still remain accommodative in 2022, as the Fed Funds rate was forecasted to be well below the 'neutral' rate, or the rate where monetary policy neither stimulates nor restrains economic growth. Such easy financial conditions will be supportive of equities and other risk assets.** Solid consumer fundamentals, including strong income growth and elevated savings rates, should support broader consumption, as well as housing markets, which underpins our **positive view on securitised credit investments**.

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The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

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Definitions

- **Agency mortgage-backed security:** Agency MBS are created by one of three agencies: Government National Mortgage Association (known as GNMA or Ginnie Mae), Federal National Mortgage (FNMA or Fannie Mae), and Federal Home Loan Mortgage Corp. (Freddie Mac). Securities issued by any of these three agencies are referred to as agency MBS.
- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Curve steepening:** A steepening yield curve may be a result of long-term interest rates rising more than short-term interest rates or short-term rates dropping more than long-term rates.
- **Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- **OER:** Owner's equivalent rent. This is the amount of rent that would have to be paid in order to substitute a currently owned house as a rental property. OER figures the amount of monthly rent that would be equivalent to the monthly expenses of owning a property (e.g. mortgage, taxes, etc.).
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **TIPS:** Treasury Inflation-Protected Security (TIPS) is a Treasury bond that is indexed to an inflationary gauge to protect investors from the decline in the purchasing power of their money.

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