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CIO Viewpoint

Fed's Powell reinforces tapering priorities of jobs, then inflation

Investment Solutions

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The US is moving closer to winding-down its historic levels of monetary stimulus as the country's economic outlook improves. That still leaves massive levels of support from the Federal Reserve to come, at a time when the American recovery is consolidating. This has profound implications for markets worldwide.

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The US economy has now met the Federal Reserve's test of "substantial further progress," the central bank's chair Jerome Powell said on 27 August at the annual Jackson Hole economic symposium, which was held virtually for a second year because of the pandemic. Based on signs of moderating inflation and improving job data, "it could be appropriate to start reducing the pace of asset purchases this year," he added. Once that tapering is complete, the Fed may then begin the process of raising interest rates. However, Mr Powell reiterated that the "timing and pace of the coming reduction in asset purchases" will not provide "a direct signal" on the timing of interest rate increases.

The Fed was quick to respond aggressively to the Covid crisis with asset purchases. Since March 2020, each month the central bank has bought USD 120 billion of assets, in US government debt and mortgage-backed securities. That soothed nervous markets, allowing the US to weather the worst impacts of the sharpest economic crisis in recorded history. The combination of historically-low interest rates and asset purchases has driven stock markets to record levels this year as companies finance their debt more easily and investors chase returns. As the US economy has emerged from the pandemic's lockdowns, consumer demand and supply bottlenecks have driven inflation, particularly in those sectors worst affected by Covid, including travel, eating out and second-hand vehicles.

In retrospect, injecting economic support as the pandemic struck was the easy part. The Covid recovery still presents challenges to monetary policy. Almost since the Fed started its latest quantitative easing (QE) purchases in 2020, investors have wondered how they could be withdrawn. No one wants to repeat 2013's 'taper tantrum,' when the Fed surprised markets with a plan to phase-out QE. Emerging markets are particularly vulnerable to rising US interest rates, because they directly impact the financing costs of much of their existing borrowing, as well as tightening their ability to borrow more.

Key takeaways

- Stabilising US inflation and improving job market leaves Fed's agenda to taper stimulus on track
- With inflation pressures easing, the Fed remains focused on broad-based recovery in employment
- First reductions in asset purchases may come as early as November with rate 'liftoff' in 2023
- We monitor the Fed's monetary policy normalisation and implications across asset classes.

A broader reading of unemployment

As a result, Mr Powell makes a point of communicating clearly. Last week, he repeated his criteria of "maximum employment and price stability," in that order, when discussing the plan to withdraw stimulus and raise interest rates. With inflation slowing in July, the Fed chair referred to price spikes as "transitory" four times and made 11 references to "maximum employment" as a criterion for raising interest rates. It is not yet clear whether "maximum employment" means returning the US to the same 50-year low of 3.5% joblessness recorded just before the pandemic in February 2020. It seems likely that the Fed is looking at broader measures.

The US economy added 943,000 jobs in July, its fastest improvement in almost a year. Unemployment rates for African Americans are close to historical lows for the past five decades, and the numbers of "prime-age" workers, a figure unaffected by an ageing population and a preferred measure of Mr Powell, has also improved. However, parts of the employment market have not kept pace with the recovery, and the jobless rate, which peaked at 14.8% in April 2020 and fell to 5.4% in July this year, masks a fall in labour market participation. There are 5.7 million fewer jobs than before Covid. As opportunities in restaurants, hotels and entertainment reappear, many workers seem to have dropped out of the market.

The Fed's balance sheet

Thanks to its monthly asset purchases, the Fed has now acquired more than USD 4 trillion of assets through the pandemic, worth 18% of the US economy's Gross Domestic Product and almost doubling its balance sheet to USD 7.45 trillion since February 2020 (see chart). Assuming no surprises, if the Fed were to wind-down asset purchases starting in January 2022 by USD 10 billion per month from the USD 120 billion per month currently, its total balance sheet would reach USD 8.3 trillion.

The size of the Fed's balance sheet matters because QE's government bond purchases leave fewer 'safe' assets available to investors, pushing them to invest portfolios in riskier assets. In turn, that can ease financial market conditions, an effect that otherwise can only be achieved through lower interest rates.

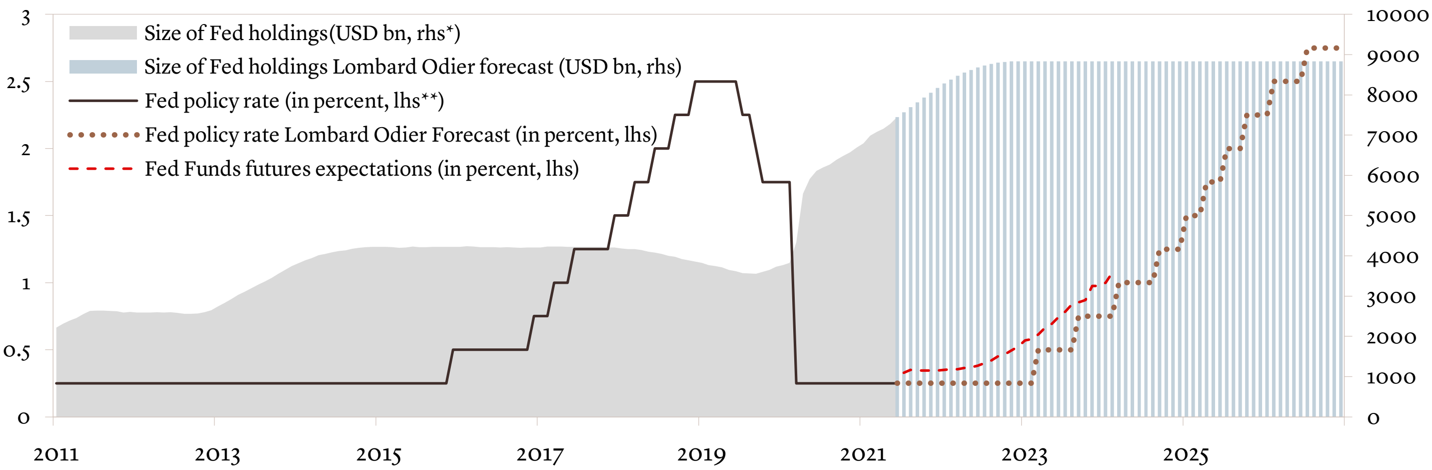
Taper largesse

Discussions around taper timing should not obscure the fact that, if the process were to begin in January next year, the Fed would buy as much as another USD 1.14 trillion of assets between now and November 2022. Of this total, USD 660 billion would be purchased in 2022 during the tapering process, and presumably at a time when the US economy would be expanding toward "maximum employment" with inflation hovering around 2%.

At the very least, even if the tapering process kicked-in as early as November, after an announcement at the next meeting of the Federal Open Market Committee on 21/22 September, the Fed would still buy another USD 900 billion in assets.

Economists including Larry Summers, a former US Treasury Secretary and Harvard University professor, point to the positive US data and have called for an end to quantitative easing much faster than the Fed's outline. Mr Summers also argues that the Fed is underestimating US inflation risks.

Federal Reserve Balance Sheet & Policy Rate Outlook



Sources: Bloomberg, Lombard Odier
*rhs : right hand scale. **lhs: left hand scale

With consumer demand pushing inflation beyond the central bank's target, Mr Powell's response is that the Fed's average inflation targeting (AIT) approach, unveiled a year ago, will be flexible enough to respond to evolving data. That is because AIT allows the Fed to 'look through' short-term spikes rather than systematically raise interest rates in response to rising inflation.

At the current pace of the US's economic recovery, we expect a first interest rate hike to follow the completion of tapering, and a period of stability in the size of the Fed's balance sheet, in other words no earlier than January 2023.

Mr Powell's four-year term as chair of the Fed ends in February 2022. President Joe Biden is expected to re-appoint him to a second term, and he is already reported to have the support of his predecessor at the Fed, Treasury Secretary Janet Yellen. The test of Mr Powell's first term was his ability to insulate the US from the worst impacts of the Covid crisis. A second term would be defined by his ability to withdraw support without tripping the economy into another recession as interest rates rise and the costs of debt increases. That will mean US interest rates would not return to pre-pandemic levels until the end of that second term, around 2025.

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