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United States: Fed tapering likely to start by the end of 2021

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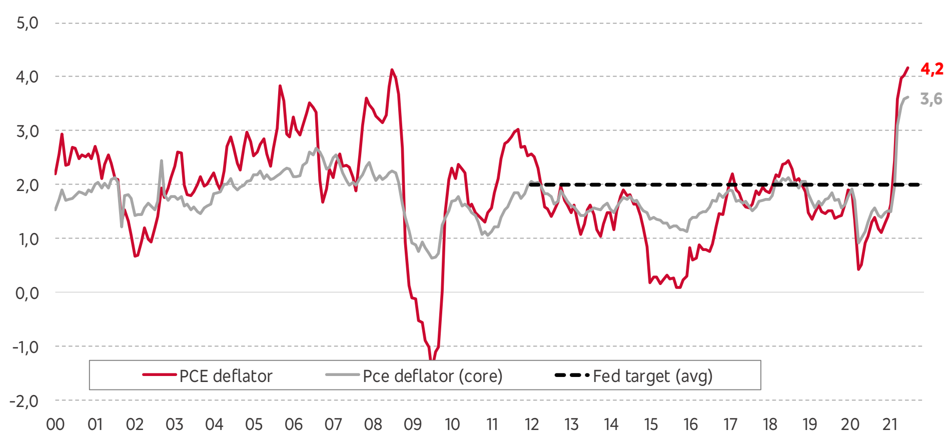
The U.S. Federal Reserve has signaled the first concrete step towards normalizing its monetary policy. According to the latest minutes of the latest Federal Open Market Committee (FOMC) meeting, the majority of members believed that if the economic recovery continues at the current pace, it will be appropriate for the Fed to start tapering its asset purchases program by the end of 2021. With that, the much-anticipated speech by Fed Chairman Powell at the annual Jackson Hole symposium served to clarify some points, but did not bring any concrete changes to the outlook for monetary policy.

Most Fed members consider that the inflation trajectory meets the significant progress goal established under the new policy framework[1]. Both headline and core PCE deflator[2] rose well above the 2% target. For the 12 months ending in July, the overall PCE inflation rate stood at 4.2%, while core PCE inflation reached 3.6%.

Chart 1: PCE deflator
(12-month rate)



Source: BEA

[1] In the new monetary policy framework announced last year (https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf), the Fed concluded that evidence from recent years indicates that the economy can operate at historically low levels of unemployment for longer, with beneficial effects on welfare, without this translating into inflationary pressure, leading it to adopt a goal of promoting maximum employment. With respect to prices, the Fed concluded that monetary policy should pursue the inflation target symmetrically, with inflation remaining slightly above the target for approximately the same time that it remained below the target. This framework serves to counter the idea that the Fed will anticipate inflation before it reaches the target, causing long-term inflation expectations to converge to a level below the Fed's target.

[2] Price deflator for personal consumption expenditures, calculated by the BEA – the main inflation measure used by the Fed in setting monetary policy.

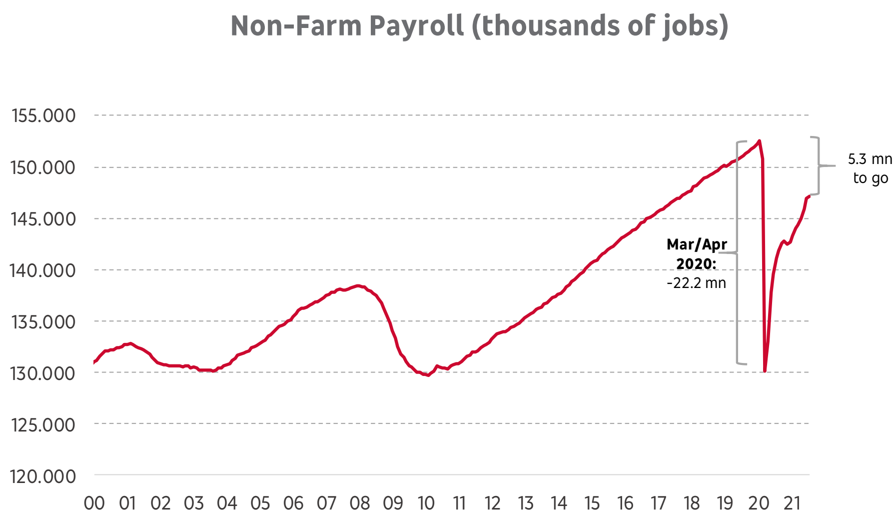
These levels certainly meet the goal of bringing inflation slightly above 2%. The question that remains among some FOMC members is whether inflation will remain above 2% or whether inflation will be transitory, associated to the reopening of the economy, and the primary monetary policy challenge in the near future will be to try to prevent deflation due to structural factors, such as demographics or globalization.

The argument that inflation has a strong transitory component has its merits. Headline inflation for the 12 months ending in July was 5.3%, while core inflation (excluding food and energy) was 4.2%. Perhaps the item that saw the biggest impact from tightening supply and the reopening of the economy was "used cars," which rose 41.7% in the period. If we exclude only this item from the consumer price index, we would have an annual headline inflation at 4.2% and core inflation at 3.1%.

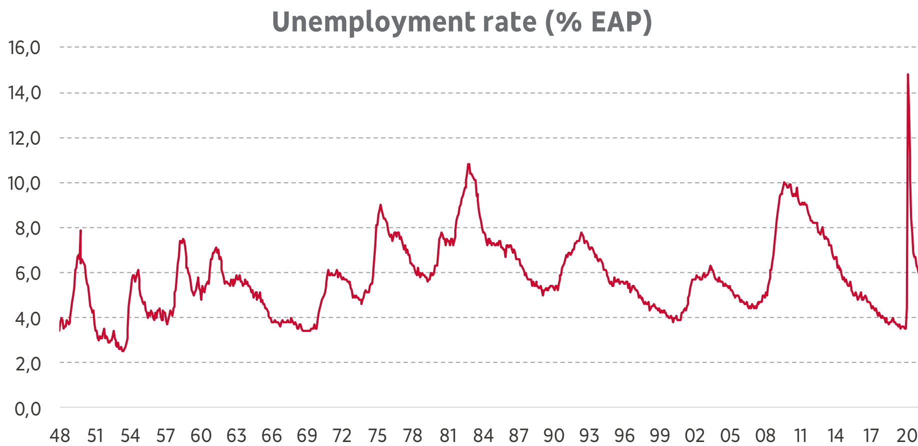
On the other hand, the annualized consumer price index (CPI) since the beginning of the pandemic stood at 3.6%, while the core reading was 3.2%.[3] Even if we exclude the extraordinary increase in the price of used cars in the period, we would still have headline inflation at 2.8% and core inflation at 2.4% – comfortably above the inflation target while still taking into account both the deflation of the beginning of the pandemic and reopening inflation.

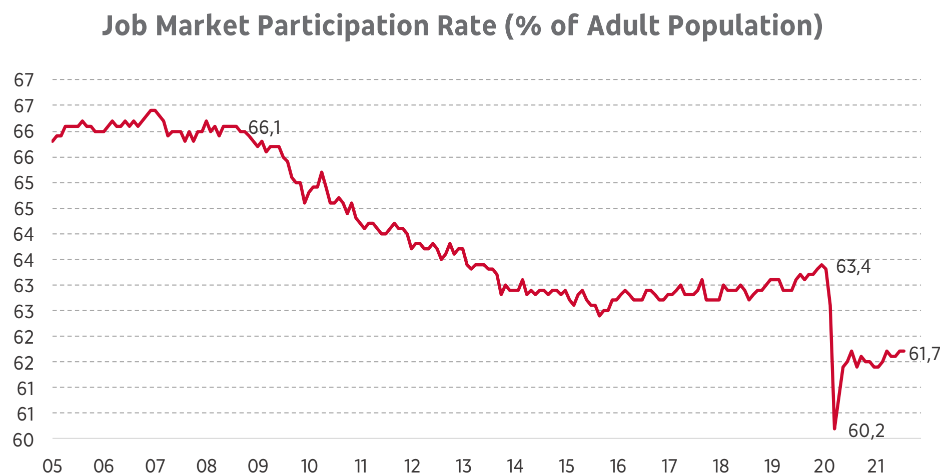
As for the job market, Powell admitted that prospects have improved significantly in recent months, though the maximum employment goal had not yet been met. In July, there are still 5.7 million jobs for the economy to return to pre-pandemic employment; the unemployment rate dropped to 5.4%, but it is still almost 2 percentage points above February 2020 and the labor market participation rate is still far from returning to normal. But Powell points out that the U.S. has been adding on average 832,000 jobs per month this year – the strongest pace of hiring ever – and that the number of people changing jobs – possibly to more advantageous roles – is at record levels, with employers reporting difficulties filling open positions in the private sector.

Chart 2: Job Market Indicators



[3] For the 17 months from February 2020 to July 2021, headline CPI was 5.2% and core CPI was 4.6%.





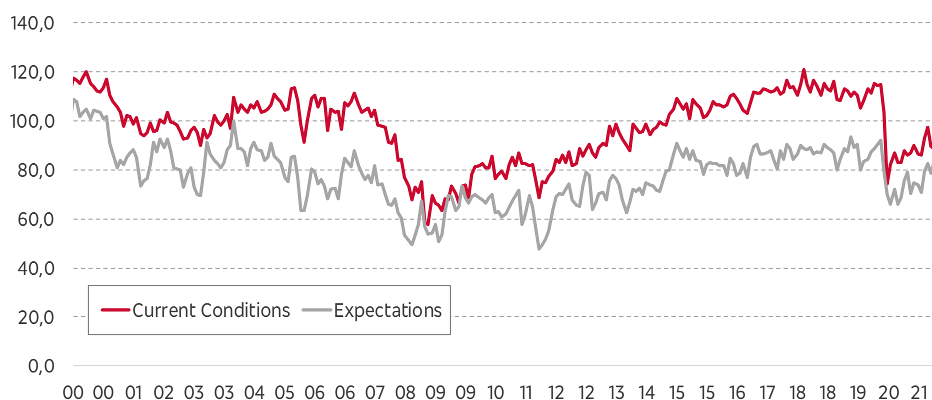
Source: BLS

There is an expectation that the reopening of schools and the end of emergency unemployment assistance programs will allow for the normalization of the labor supply. Thus, Powell's speech signals that, in general, that the Fed will be ready to start tapering if the job market keeps its current pace.

At the same time, the Fed admits that there are some concerns about the effects of the Delta variant of COVID-19 on the reopening of the economy. The FOMC meeting minutes show that several committee members are willing to adjust their views on tapering if a worsening of the pandemic derails the ongoing recovery. In his speech, Powell himself noted that in addition to job market improvements, July also saw a worsening of the pandemic.

Evidence that the economy has been losing steam as a result of the pandemic has begun to materialize. Consumer metrics, such as retail sales, have stopped growing on the margin, but remain at a high level. Supply problems in the automotive sector were expected to depress sales in July, but even the sectors most associated with reopening, such as apparel, department stores and even the bar and restaurant industry, came in below expectations. In addition, consumer confidence has been raising some concern, highlighted by risks related to consumption in the coming months. It is also a fact that U.S. confidence indicators are very sensitive to inflation, so the sharp drop in the expectations index cannot be attributed solely to concerns about the Delta variant either.

Chart 3: University of Michigan Consumer Confidence



Source: Surveys of Consumers, The University of Michigan

For these reasons, we cut our 2021 U.S. GDP forecast from 7.0% to 6.1% In addition to these signs of loss of growth momentum, associated with inflation and the pandemic, Q2 GDP fell short of expectations (annualized growth of 6.5%, compared to 9%). It is important not to exaggerate the impact of this revision on the overall economic outlook. The negative surprise with Q2 GDP was due to the negative contributions from inventory changes and net exports, since household consumption was up 11.8%.[4] The 2022 forecast remains virtually unchanged at 4.4%.

Our conclusion is that the Federal Reserve will look for more data before finalizing the decision to start tapering*, but we believe we are close to that moment.* If the pandemic does not worsen, and job creation in the coming months remains somewhere close to the rate recorded so far, we believe that there is a great chance that the Fed will confirm its intentions in September[5] and start tapering at its November 3 or December 15 meetings.

Perhaps more important than the start date for tapering *will be how quickly the Fed decides to taper off its purchases.* Even with the Fed reaffirming that an eventual interest rate hike will be separate from the discussion on tapering, the market will probably extrapolate the reduction in purchases to speculate on the beginning of rate hikes. For example, if the Fed reduces its monthly purchase of Treasury bonds by USD 10 billion and of mortgage-backed securities by USD 5 billion per meeting, the market will likely speculate that the purchase program will end 8 meetings later (currently, the Fed buys USD 80 billion worth of Treasuries and USD 40 billion in MBS monthly*6*, so interest rates could start to rise as early as late next year.

The tapering announcement could kick off a period of greater volatility for Treasuries*, as the market assesses the probability of an interest rate hike still in 2022 or early 2023.* In addition, the Fed will have to open the discussion on reducing its balance sheet, whether by rolling only the principal, but not the interest coupons, or only part of the principal maturities.

[4] The negative contribution of changes in inventory to the annualized GDP of 6.5% was 1.1 pp, and net exports, 0.4 pp. The increase of 11.8% in household consumption had a positive contribution of +7.8 pp in the quarter.
[5] At the next meeting, the FOMC will also release an update on its members' economic projections, which could be another important communication tool.
[6] *Mortgage Backed Securities, issued by federal agencies Fannie Mae and Freddie Mac.*

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