

GIAM Macro & Market Research- Market Commentary

The Fed is more confident on the recovery and brings forward to 2023 the first hike

- The Fed is projecting a faster return to normality, and therefore monetary normalisation could be speeded up; two hikes in 2023, bringing the Fed funds rate to 0.625%, are now deemed appropriate.
- Growth projections for 2021 were marked up, and expected inflation was raised. However, the medium-term forecasts remain broadly unchanged with respect to March. The spike in inflation is considered transitory.
- The FOMC started talking about tapering. No timeframe was hinted at but we expect an announcement by the September meeting.
- The surprise move lifted bond yields, especially at the short end of the curve and caused the S&P500 to lose 0.6% on the announcement.

The Fed has grown more confident in the positive signals the economy is providing and in a surprising move, brought forward to 2023 the date of the liftoff and foreseeing two rate hikes in that year. This increased confidence was visible in the tone of the press release. The reference to the past slowdown in the pace of the recovery were replaced by a strong focus on the strengthening of the economy. Importantly, the statement acknowledged that inflation is no longer running below 2%. (see comparison attached).

The FOMC forecasts for this year a sharper rebound and much more inflation than what expected in March. This is to a large extent a marking to market of recent data (see table at the end), without repercussion on the forecast for 2022 and 2023. The end of the fiscal support will slow down growth, which however will remain well above the 2% potential. Inflation is then expected to revert to a more sluggish dynamics, remaining just above the 2% target in both years. By 2023, with unemployment back at the decades-low of 3.5% reached just before the pandemic outbreak, the conditions for lift off would then be met..

Chair Powell tried to play down the role of dots, saying that two years is a long time and discussing liftoff remains premature. Moreover, dots are a poor forecaster of the actual Fed moves.

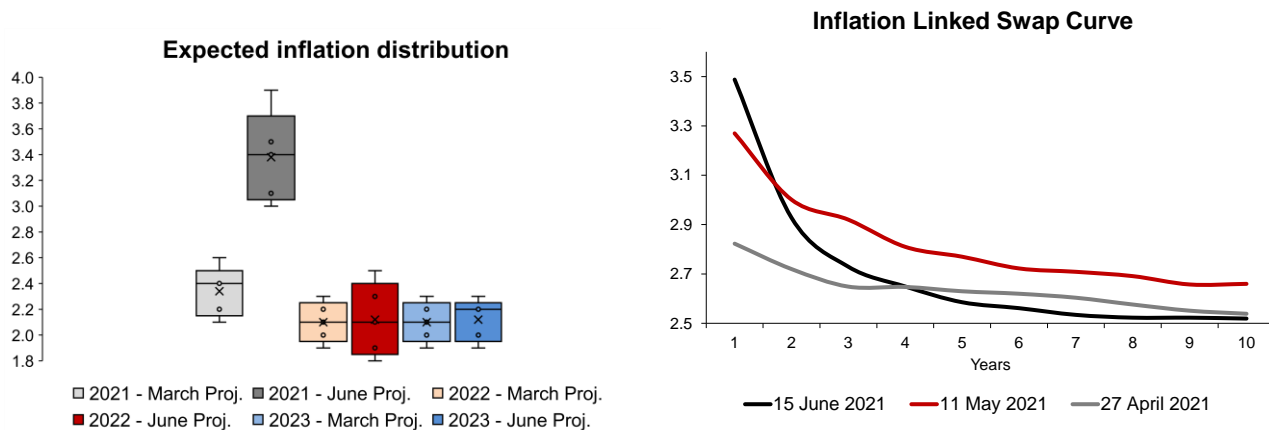
Median projections				
	2021	2022	2023	Longer run
Change in real GDP	7.0	3.3	2.4	1.8
<i>March projections</i>	6.5	3.3	2.2	1.8
Unemployment rate	4.5	3.8	3.5	4.0
<i>March projections</i>	4.5	3.9	3.5	4.0
PCE inflation	3.4	2.1	2.2	2.0
<i>March projections</i>	2.4	2.0	2.1	2.0
Core PCE inflation	3.0	2.1	2.1	

<i>March projections</i>	2.2	2.0	2.1	
Appropriate Fed funds path				
Federal funds rate	0.1	0.1	0.6	2.5
<i>March projections</i>	<i>0.1</i>	<i>0.1</i>	<i>0.1</i>	<i>2.5</i>

The change in the outlook for the Fed fund rate was not accompanied by any clear signals on tapering. However, Chair Powell conceded that in this meeting FOMC talked about talking about tapering. The substantial progress needed to trim asset purchases are not met yet, but there is an increasingly strong confidence that the economy is heading in the right direction. Yet more clarity on the timing requires more data; we continue to expect more information to be disclosed at the Jackson hole meeting (August 26-28). Given the brighter outlook painted by the Fed, details on the tapering are very likely to be communicated at the September 22 meeting.

Most of the Q&A session was devoted to providing details on the inflation and the employment outlook.

On inflation chair Powell insisted that, while the strength of the April and May prints was surprising, the FOMC view remains unchanged. When the economy normalises, the structural factors which have moderated inflation during the last decades will become more visible, and the dynamics will be entirely affected by the improvement in the labour market. The distribution of the FOMC members' views on inflation shows a rather high degree of confidence in such an outcome. And financial markets too are showing increasing conviction about this view.



According to Chair Powell, long term inflation expectations have risen back and are now “in a good place”, consistent with the 2% inflation target. The risk of them showing signs of unanchoring was not dismissed, but there is at the moment no evidence of that. One can read the move from zero to two hikes in 2023 as a mean to show the Fed’s commitment to avoid inflation slippages. The labour market continues to evolve toward full employment, but, as chair Powell stressed, the economy is still far away from it both in term of aggregate outcomes and distribution of the job gains across groups. Chari Powell stressed the role of participation to the labour market in shaping what the Fed views as full employment. Shorter term the Fed expect very strong and fast progresses in job creation, looking though bottlenecks and “speed limits” due to skill mismatches. Fast employment growth is not yet accompanied by worrying wage pressures.

Finally, the FOMC raised both the IOER and RRP rates by 5bp (to 0.15% and 0.05%). Powell stated that the Reserve Repo facility is doing a good job at keeping a smooth functioning of the money market.

Markets were taken by surprise by the evidence of a less patient Fed. The 10-year Treasury yield took 0.06 bps on the announcement, reaching 1.56%, with sharper moves up at the short end of the curve. The S&P fell by 0.6%, driven down by technology companies.

Variable	Previous FOMC meeting	Latest	Chg. Since Prev. Meeting
Real Activity			
GDP (% yoy)	-2.4	0.4	2.8
Weekly activity index (scaled to yoy GDP)	12.0	10.2	-1.9
ISM - Manuf	60.7	61.2	0.5
ISM - Services	62.7	64	1.3
Macro Surprises	43.3	50	6.7
Labor Market			
Payroll growth (3 mth. MA)	518	541	23
Unemp. Rate	6	5.8	-0.2
Unemp. Rate (broad)	10.7	10.2	-0.5
Hourly wages, % yoy (3 m. MA)	5	2.7	-2.3
Prices			
Core CPI	1.6	3.8	2.2
Core PCE	1.9	3.1	1.2
Trimmed PCE	1.7	1.8	0.1
U. Mich 5 yr exp.	2.7	2.8	0.1
NY Fed 3 Y exp.	3.1	3.6	0.5
5Y5Y fwd exp.	2.3	2.3	0.0
Financial Conditions			
Chicago Fed index*	-0.70	-0.72	-0.02
10 yr. Treasury	1.62	1.50	-0.12
- Risk neutral Component	1.23	1.22	-0.01
- Term Premium	0.40	0.28	-0.11
Yield curve (10Y - 2Y)	1.45	1.33	-0.12
S&P 500	4183.2	4246.6	1.5%
Trade Wighted Dollar	118.5	118.0	-0.4%
WTI Crude Oil	63.9	72.1	12.9%

* Decrease: looser conditions

Author:

Paolo Zanghieri

paolo.zanghieri@generali.com

www.generali-investments.com

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