

Fed accelerates tapering, projects 3 rate hikes in 2022

The December meeting of the US Federal Reserve saw it announce an acceleration in the pace of QE tapering. Beginning in mid-January, it will reduce its rate of monthly asset purchases by \$30bn (a \$20bn reduction in Treasuries purchases and \$10bn in mortgage backed securities). This is a doubling of the initial pace of €15bn of tapering announced in November. The decision was in line with market expectations. The Fed did keep its options open regarding future tapering by stating that it will adjust the pace if “changes in the economic outlook” warrant it. Based on the new pace, net purchases would cease in March of next year. The Fed, kept the funds rate in its target range of 0.00-0.25%. There was unanimity within the Federal Open Market Committee (FOMC) on the policy announcements.

Meanwhile, the meeting statement saw the Fed remove the word transitory in its description of the factors that are driving inflation higher. This was already signaled by

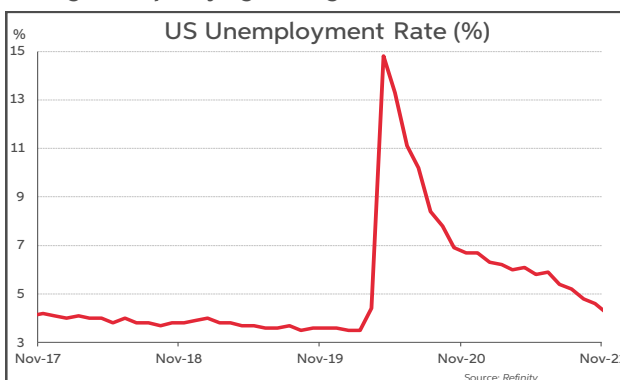
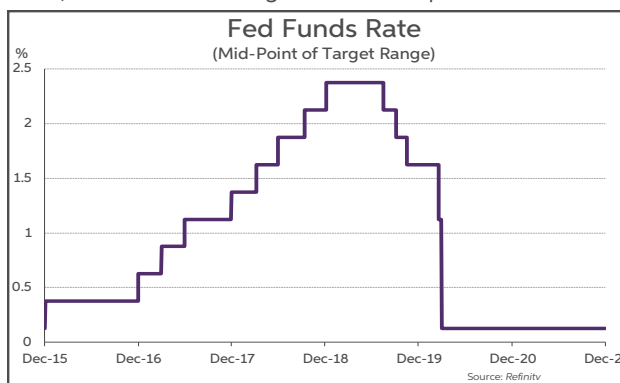
Chair Powell’s Congressional testimony in late November. During last night’s press conference, he stated that price increases have now “spread to a broader range of goods and services”, while wages had also increased “briskly”. Meantime, the Fed acknowledged that “new variants” of the virus posed risks to the economic outlook. The central bank modestly downgraded its GDP growth projections for Q4 2021 to 5.5% y/y (from 5.9%), and moved up its Q4 2022 forecast to 4% y/y (from 3.8%).

More significantly though, the Fed revised higher its inflation forecasts. For this year, it expects headline PCE inflation at 5.3% (from 4.2%) in Q4 and at 2.6% (was 2.2%) in Q4 2022. In terms of Core PCE, it is forecasting a 4.4% rate (from 3.7%) for Q4 2021, and 2.7% (from 2.3%) in Q4 2022. At the same time, on the back of the recent improvements in the labour market, the Fed have revised downwards its unemployment projections. It is now envisaging the unemployment rate at 4.3% in Q4’21 (was 4.8%) and at 3.5% (was 3.8%) in Q4’22.

These updates to its inflation (revised higher) and unemployment (revised lower) forecasts formed the backdrop to a further hawkish shift in its interest rate projections (i.e. ‘dot plot’). The December dots show that all FOMC members now expect at least one rate hike next year. In September, nine members anticipated no rate hikes in 2022. The median projection is for three 25bps hikes next year, compared to one small 12.5bps previously. This would leave the funds rate at 0.875% by end-2022. Meanwhile, for 2023 and 2024, the median projections are for three and two rate hikes respectively. This would leave rates at 1.625% at end-23 and 2.125% by end-24 (vs. 1.8% previously) Overall, the Fed now expects a faster and greater degree of policy tightening.

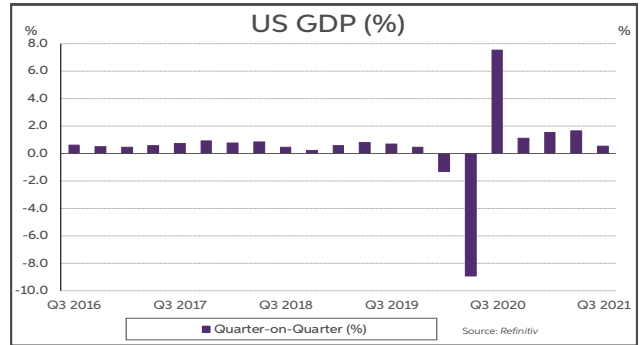
Futures contracts show the market is pricing in the first 25bps rate hike by June, although the market has not fully priced in 75bps of tightening by end-2022. Markets are looking for rates to rise by 50bps in 2023, which would leave the funds rate just above 1.375%. However, the market anticipates the pace of rate increases to slow significantly in 2024, with futures contracts consistent with the funds rate in the range 1.5-1.625% by end-year. The Fed’s own projection for end-2024 is 2.125%. Thus, markets do not see rates rising by anywhere near to the same extent as the Fed over the next three years.

In light of the latest policy changes and guidance from the Fed, the key focus over the coming months is on when will the Fed start to raise rates next year. The central bank has guided that it will finish net purchases before hiking rates, which would seem to rule out a hike in Q1. It is likely then that lift-off will happen in May or June as long as Covid risks do not derail the US economic recovery. In terms of market reaction to the Fed meeting, the dollar initially strengthened. However, it gave up these gains during the press conference, amid no signal coming from the Fed that rates could rise in the early months of 2022.



US economy regains some momentum in Q4

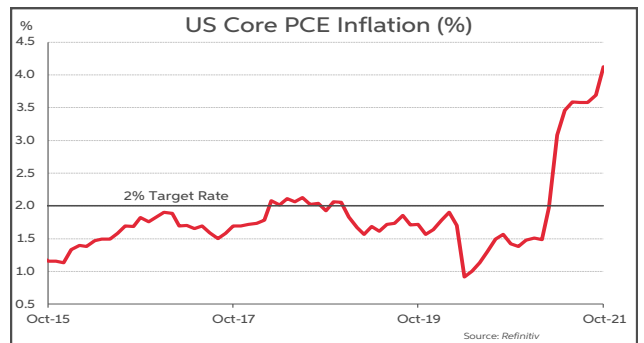
The pace of economic growth slowed considerably in the US in the third quarter. The economy expanded by 2.1% in annualised terms in Q3, down from 6.7% and 6.3%, in Q2 and Q1, respectively. In terms of the underlying breakdown, the expansion continued to be led by consumer spending, which added 1.2 percentage points (p.p.) to GDP. Government spending contributed 0.2 p.p. to growth, although this was offset by investment which clipped 0.2 p.p. from the total. Exports declined by 3%, while imports jumped by 5.8%, resulting in net trade subtracting 1.2 p.p. from growth. Meanwhile, inventories fell by less than in Q2, boosting output by 2.1 p.p. in Q3. The strong rebound in the US economy means that GDP was 1.4% above its pre-pandemic level in Q3.



Survey data suggest that the recovery has continued in Q4. Both the manufacturing and services PMIs have been little changed throughout Q4, remaining well above 50. Likewise, the manufacturing (61.1) and non-manufacturing (69.1) ISMs have printed firmly in expansion mode, with both indices above 60 in November. However, consumer sentiment has remained subdued since falling sharply in September. The elevated levels of inflation, were highlighted in both the Conference Board and the University of Michigan surveys as the main reason behind the deterioration in consumer confidence.

The latest retail sales data show they rose by 0.3% in November, while the “control group” measure (core sales indicator) fell by 0.1%. However, it should be noted that this follows a very strong rise in retail sales in the previous three months. Meantime, industrial production, which had recovered much more slowly, has regained some momentum in Q4, rising by 1.8% in October, and 0.5% in November. Recent housing data have also been strong. Thus, a marked pick-up in GDP growth seems likely in Q4.

Turning to the labour market, payrolls have continued to rise in recent months. They increased by 210k in November, down from 546k in October, leaving them still 3.9m below their pre-pandemic level. The jobless rate, though, has continued to decline, falling to 4.2% in November from 4.6% previously. The Fed now believes that the unemployment rate will fall to 3.5% by Q4 next year, its level before the pandemic began, and consistent with full employment. Encouragingly, the labour force participation rate rose to 61.8% in November also, its highest level since February 2020, although it remains a long way short of its the pre-Covid rate of 63.4%.



Meanwhile, inflation has surged from already elevated levels in recent months. CPI inflation jumped to 6.8% in November, its highest level in almost 40 years. Similarly, core-CPI rose to 4.9% in November from 4.6%. Headline and core-PCE inflation rose to 5% and 4.1%, respectively, in October. The Fed has stopped describing inflation as transitory, as on-going supply constraints are contributing to higher prices. The latest Fed projections show the core-PCE rate at 4.4% in Q4, before declining to 2.7% in Q4 2022 and 2.3% in Q4 2023.

It is clear the US economy is facing challenges. Growth has accelerated once again in Q4 though, with GDP forecast to rise by circa 6% in annualised terms. However, the jobs market recovery will take some time, and inflation is now expected to remain elevated for longer than previously anticipated, which may weigh further on real spending. Meanwhile, the President’s social spending bill is still caught in a logjam in Congress, and potential increases to the US corporate tax rate may act as a headwind to investment in the coming years. Monetary policy is set to be tightened, with significant rate hikes likely next year and in 2023. Covid-19 is set to remain a headwind also, with new variants a particular threat to an economy with still low vaccination rates. **The Fed is forecasting Q4 GDP will rise by 5.5% y/y this year and 4% y/y in 2022, before slowing to 2.2% y/y and 2.3% y/y in Q4 2023 and 2024 respectively.**

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