GIAM Macro & Market Research- Market Commentary

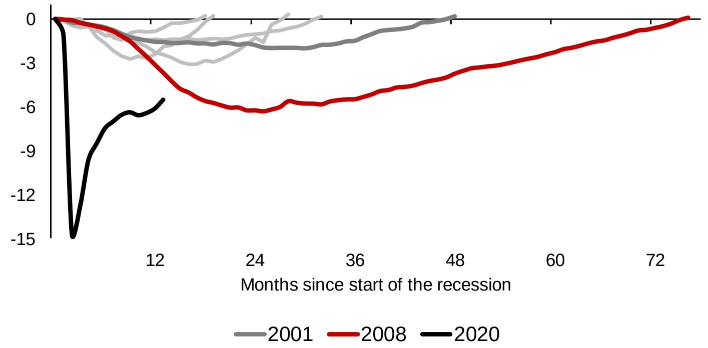
The Fed sees an improved outlook but does not change course

- **The Fed delivered an optimistic message on the state of the economy, signalling a sizeable reduction of the risks to the outlook**
- **However, the economy and especially the labour market have yet to show the substantial improvement needed to start thinking about tapering.**
- **The looming inflation spike will be transitory and will not affect inflation expectations. They are increasing but still low enough to warrant accommodation.**

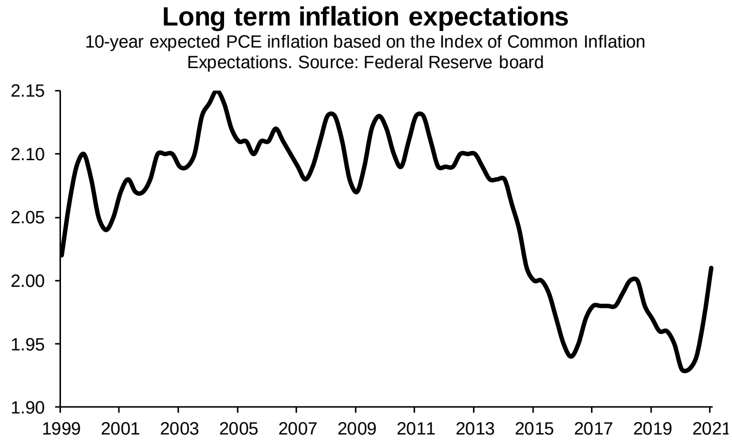
The April meeting had few surprises. The Fed marked to market its view of the economy in line with better data on vacicnatio nand activity. The evolution remains in line with its forecast and therefore does not require any policy changes, as widely expected. Indeed, the press release contained some changes in the description of the economy, most notably the fact that the risks to the economy are no longer deemed “considerable”. However, it remained unchanged from March as far as policy is concerned (see the comparison attached). Importantly the FOMC stressed the temporary nature of the incoming inflation spike.

In the Q&A session, Powell had to repeat a few times that any talk of tapering is premature. The latest data, especially those on employment were good (see table at the end) but the economy is still far away from showing the “substantial improvement” the Fed requires to reduce the pace of asset purchases. The recovery is still incomplete and uneven across sectors. Around 8 million people who lost the job due to the pandemic are still unemployed and labour market participation remains very low. The FOMC will need to see a “string” of employment gains like the 916k reported in March to start thinking about tapering. We therefore stick to our view of an announcement of tapering in Q3, followed by implementation in Q1 2022.

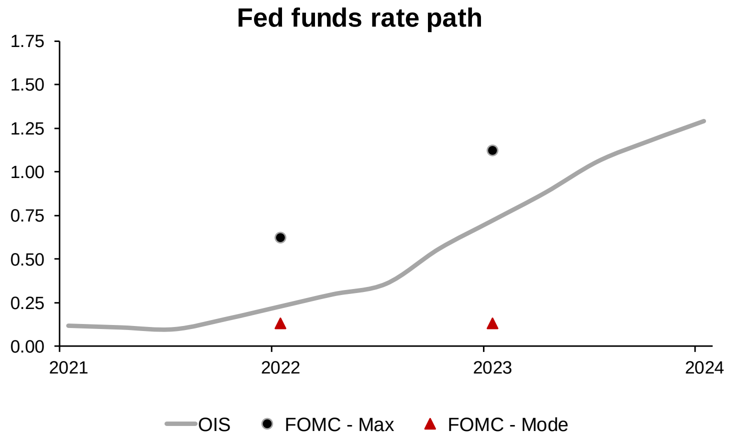
Job losses in recessions
% of pre-recession employment



Powell warned that the rise in inflation which has just started is largely due to base effect and bottlenecks originated by the reopening and this temporary spike will not count to the averge 2% inflation the Fed is targeting. Base effect will increase core inflation by around 0.7 pp for a few months while it is harder to pin down the size and duration of the impact of bottlenecks, which however will be temporary, as they derive from a one-time shift in the price level. The inflation move is not expected to influence expectations. They have indeed risen, back to the 2018 level, but do not show any sign of deanchoring.



As in the case of tapering, Powell reiterated that it is far too early to think about interest rate hikes, as full employment is still far away, and inflation has to rise to just above 2% for some time to compensate the prolonged shortfall from the target. Reiterating this message is crucial to convince markets, which continue to price the first rate hike as early as in H1 2023.



High and rising house prices are a concern related to affordability, but the expected increase in supply will take care of that. It is not a worry for financial stability as household finances are in a good shape and bank capitalisation strong. The price of a few asset is “frothy” but according to Powell this mainly reflects the optimism brough about by the successful vaccination campaign and the reopening of the economy. On the supervision side, some attention will be devoted to money market and bond funds and to the structure of the market for Treasuries, which showed strains when the pandemic struck. In particular, bond dealers will have to step up capital buffers to cope with the increase in the supply of Treasuries.

Variable	Previous FOMC meeting	Latest	Chg. Since Prev. Meeting
Real Activity			
GDP (% yoy)	-2.4	-2.4	0.0
Weekly activity index (scaled to yoy GDP)	-0.3	11.8	12.2
ISM - Manuf	60.8	64.7	3.9
ISM - Services	55.3	63.7	8.4
Macro Surprises	31.3	44.2	12.9
Labor Market			
Payroll growth (3 mth. MA)	131	539	408
Unemp. Rate	6.2	6	-0.2
Unemp. Rate (broad)	11.1	10.7	-0.4
Hourly wages, % yoy (3 m. MA)	5.3	4.9	-0.4
Prices			
Core CPI	1.3	1.6	0.3
Core PCE	1.5	1.4	-0.1
Trimmed PCE	1.8	1.6	-0.2
U. Mich 5 yr exp.	2.8	2.7	-0.1
NY Fed 3 Y exp.	3.0	3.1	0.1
5Y5Y fwd exp.	1.9	2.3	0.3
Financial Conditions			
Chicago Fed index*	-0.65	-0.68	-0.04
10 yr. Treasury	1.64	1.62	-0.02
- Risk neutral Component	1.14	1.24	0.10
- Term Premium	0.50	0.38	-0.12
Yield curve (10Y - 2Y)	1.51	1.44	-0.07
S&P 500	3974.1	4186.7	5.3%
Trade Wighted Dollar	119.8	118.6	-1.0%
WTI Crude Oil	64.6	62.9	-2.6%
* Decrease: looser conditions			

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