GIAM Macro & Market Research- Market Commentary

The Fed sticks to its plans despite looming demand surge and market worries.

- **The message sent at the March meeting was one of strong continuity: short-term forecasts for growth and inflation were revised substantially up, and the healing of the labour market is expected to proceed faster. However, the medium-term view did not change much, especially for inflation.**
- **As a consequence, the monetary policy path remains the same: no rate hikes are deemed appropriated before end-2023. Similarly, any talk of tapering remains premature. Any change of direction is predicated on actual data, not on expectations.**
- **The rise in bond yields was put into perspective: overall financial conditions remain favourable and do not require any changes to the composition of bond holdings. On banking, changes to the leverage regulation and to restrictions on dividend are forthcoming, but not details were provided.**

In the March meeting the Fed showed a strong conviction that the sizeable rounds of fiscal stimulus will have only a transitory effect on the economy, not capable to driving substantially up expected and, above all, realized inflation. GDP forecast were raised markedly only for 2021 on the back of the fiscal stimulus. Full employment will be reached in 2023, but inflation will be by then only marginally above target. Therefore, FOMC members feel no need to alter the projected path of Fed funds rate.

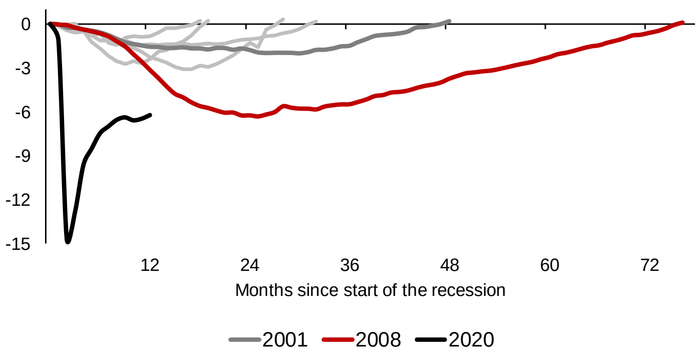
Median projections				
	2021	**2022**	**2023**	**Longer run**
Change in real GDP	6.5	3.3	2.2	1.8
Dec. projections	4.2	3.2	2.4	1.8
Unemployment rate	4.5	3.9	3.5	4.0
Dec. projections	5.0	4.2	3.7	4.1
PCE inflation	2.4	2.0	2.1	2.0
Dec. projections	1.8	1.9	2.0	2.0
Core PCE inflation	2.2	2.0	2.1	
Dec. projections	1.8	1.9	2.0	
Appropriate Fed funds path				
Federal funds rate	0.1	0.1	0.1	2.5
Dec. projections	0.1	0.1	0.1	2.5

The press statement contained only a few changes with respect to January (see comparison attached), reflecting both the improvement in macro data since the last meeting but also the need not to be carried away, as the service sector is still suffering. The weakness of realised inflation was duly noted, as a counterpoint to market worries about a possible overheating. The sharp increase in yield was not mentioned.

During the press conference, chair Powell detailed better the FOMC view on the economy and the labour market. Short term developments have been more positive than expected. The sectors most affected by the pandemic have recovered around 2/3 of the job losses. However, 9.5 million people are still jobless. The official employment rate (6.5% in February) understates the damages done to labour market participation. Getting the economy back on full employment (Powell refrained again from presenting a specific definition or a list of preferred indicators) will take time and remains the overarching objective of the Fed.

Job losses in recessions

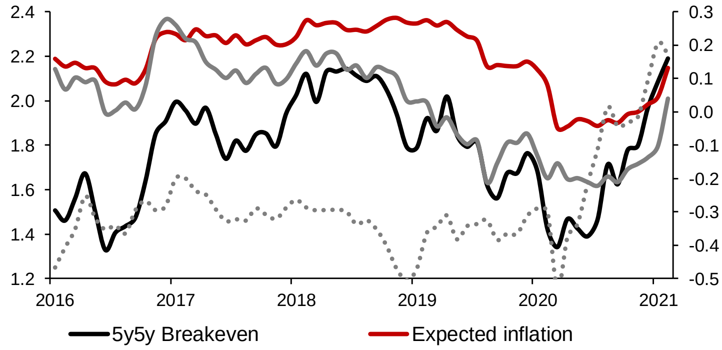
% of pre-recession employment



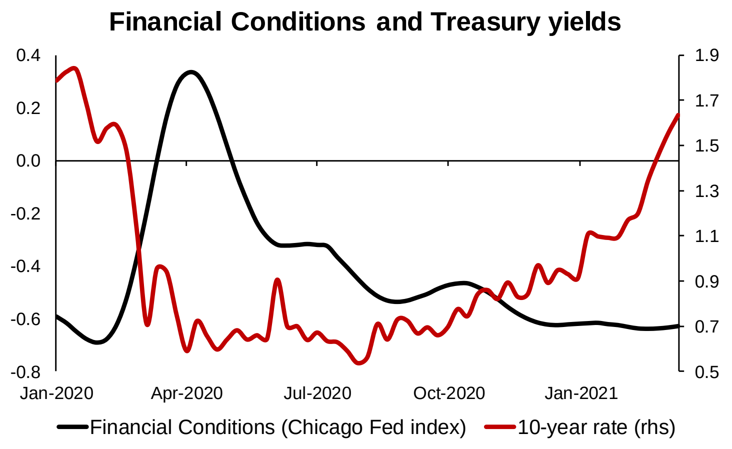
On inflation. Powell reminded that base effects and price level increases following the strong reopening of the economy and the possible supply bottlenecks it will entail, will trigger a bout of inflation in the coming months. This will lift PCE inflation to 2.4% this year, well above the 2% target, but this, being mostly a one-off rise in the price level, will not count to the inflation average the Fed is targeting. The FOMC strongly believes that the inflation regime has not changed because of the pandemic and inflation will continue to respond slowly to the reduction in slack. Importantly, he reiterated that the Fed will only react to realized inflation being stably at 2% and drifting marginally up, not to inflation forecasts. Reacting to actual data should help inflation expectations remain anchored. The Fed keeps a lot of ambiguity about by how much inflation will be allowed to overshoot, but Powell ensured that the central bank will communicate it in due time. Currently, inflation expectations do not show signs of instability; those from breakevens, once risk premia are stripped out, are back to the pre pandemic levels.

Decomposition of the 5y5y breakeven

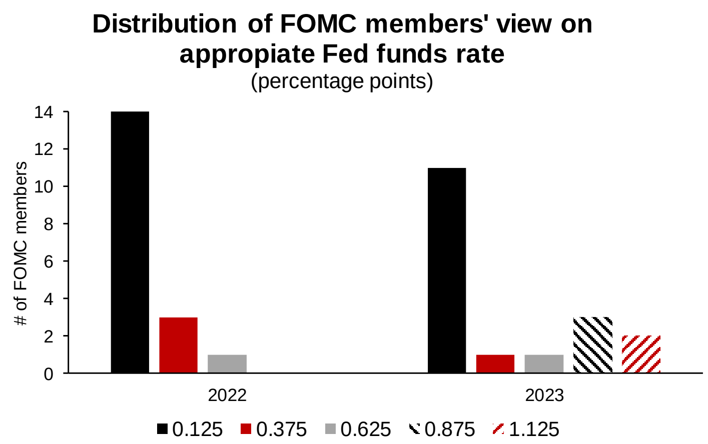
Source: DKW model, Federal Reserve Staff estimates



The spike in long term yields got relatively little space in the Q&A session. Powell said that Treasury yields are just one of the financial indicators the Fed is monitoring. Overall, financial conditions remain very accommodative. Action will be taken only if they show signs of a disorderly tightening. Similarly, risks to financial stability remain contained, the Fed is mostly concerned about avoiding another breakdown in short term funding.



Therefore, the policy path does not change. The decision to keep rates at the zero bound until end-2023 was defined as consensual. Yet some FOMC members are tuning hawkish: 4 out of 18 members think at least one hike needed already 2022, the number increases to seven for 2023. But this, according to Powel, only reflects the diversity in the forecasts (surrounded by unprecedented uncertainty), not divergencies in the approach to monetary policy. On asset purchases, the pace and composition does not change. It is not yet time to think about thinking about tapering, but communication will adapt to signal any shift with as much notice as possible.



On the banking sector, important changes to the Supplementary Leverage Ratio and on leverage regulation will announced for the next few days. Decisions on the restrictions on dividend and buybacks will be taken soon too. But Powell did not supply any details.

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