November 8, 2021

Fed Tapering of Asset Purchases to Begin as Inflation Heads Higher

Transcript

Bill Emmons: Hi. I'm Bill Emmons, and I'd like to talk to you about the FOMC meeting that took place November 2 and 3. The interest rate targets were unchanged. The big news was that the Fed will begin to taper its bond purchases this month. So, the Treasury purchases will decline from 80 to 70 to $60 billion in the months ending in November, mid-December, and mid-January. The agency MBS purchases will decline from 40 to 35 to $30 billion on the same timetable. The committee will wait until the December meeting to determine the purchase pace after that.

So now, looking into 2022 at the announced pace of purchasing, the net bond purchases could cease by July of 2022, and the FOMC prefers not to talk about or even think about raising interest rates until after the bond purchases are complete. So, the economic backdrop, I think, can really be characterized by a specter haunting the economy. It's inflation. At the press release, the FOMC said inflation is elevated, largely reflecting factors that are expected to be transitory. That hasn't been clearly fleshed out what “transitory” means. In the post-meeting press conference, Chairman Powell said that he expected inflation readings to come down only by the second or third quarter of 2022, and that's really the first indication of timing that we've gotten from the FOMC.

So, personal consumption expenditures inflation, PCE inflation—which the Fed uses as its target measure—that could hit five percent by the end of this year. And, according to Chairman Powell's looking into the future, possibly could be well above the two percent range the FOMC would like to see even by next Halloween. So, looking at the year-over-year change in the PCE inflation measure in the red line in this chart, it's already over four percent through September of this year. If you look at the nine months of 2021 so far and annualize that, put it as if it were running at a 12-month pace, that's over five percent. So, looking into 2022, if this inflationary pressure continues to build, we could easily see five percent readings on this PCE inflation measure by the end of this year and possibly into the middle of next year. Only then, according to Chairman Powell, could we expect to see those inflation readings going down toward the two percent.

At the same time, employee compensation is headed higher. Here, the employment cost index, which takes both wages and benefits into account, has been rising. Again, the red line here shows the four-quarter year-over-year change, and then the blue line is the three-quarter that we've seen so far in 2021 expressed on an annualized basis. And those are pushing toward four percent and possibly then slacking a little bit after that. But if you compare the rate of employee compensation growth to inflation, you can see that inflation is outrunning that compensation growth. So, in real terms, employees are actually losing ground at this point, even though wages and compensation have been growing pretty fast relative to recent history.

So, the financial markets are definitely pointing toward interest rate increases in 2022. According to the Fed Fund's futures market, the odds are about three to one in favor of at least one rate hike by July of 2022. The picture here shows, for each of those quarter point ranges, the odds derived from futures and options prices of where that range might be at the July 2022 horizon. Looking a little further ahead into February of 2023, so a little over a year into the future, the market is putting 50/50 odds that we will have seen at least three or more rate increases by that time. So, the markets are definitely looking toward rate increases next year and certainly by 2023.

So, implications for banks: the Fed expects the economy to continue to grow very rapidly in the fourth quarter after a COVID and supply chain-induced slowdown in the third quarter of this year. Product and labor market shortages will continue to constrain many businesses. Credit quality is likely to remain strong as economic growth continues and financial conditions are supportive, and I would say commercial and residential real estate prices appear well-supported, at least for now.

So, what should we expect? Frankly, there's no relief in sight for supply chain and labor market blockages. We thought by the end of 2021 we'd start to see some relief. Now, it looks like that's going to last well into 2022. Inflation ratings are likely to move higher in the months ahead, and as I showed, employee compensation costs also are rising, even though they are trailing inflation at this point. So, I think high inflation could push Treasury yields—particularly in the one to 10-year maturity range—higher, as they've already moved higher this year as pressure builds for the Fed to respond with some rate hikes. And yet, the FOMC, as attested by this meeting, remains very patient, even as markets are now penciling in rate hikes for the middle of 2022 and beyond.

Thanks for listening, and we'll see you next time.

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