10 May 2021

Fed Monitor

"Still a long way to go" – Fed is currently 'employment-based'

Key takeaways

- The Fed remains outcome-based (or, to be more precise, employment-based near-term) and with the weak jobs report on Friday, we do not expect the Fed to change policy signals near-term. The likelihood of a hawkish shift already in June has declined.
- The Fed still thinks the labour market recovery has *"a long way to go"*, which seems to have become the new mantra. The Fed does not expect the high inflation prints to continue, when base effects start to drop out.
- We are still more upbeat on the labour market recovery than the Fed and still expect the Fed to move in a more hawkish direction in September Actual tapering is likely to begin in January 2022.

Last week: "Still a long way to go"

Based on recent Fed speeches, consensus among the FOMC members is that the economic outlook looks brighter due to mass vaccination (reducing risks and uncertainty) but that the economic recovery still has "a long way to go", which seems to be the key phrase at the moment. Also, most FOMC members recognise that inflation is now higher but they expect inflation to move lower again, as base effects drop out and demand moves back into services away from goods. **The Fed remains outcome-based**.

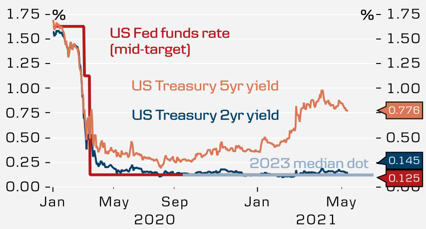
Growth/Labour market: Fed needs to see big jobs numbers

After the weaker-than-anticipated jobs report on Friday, it is important to stress that everything seems to be about the labour market recovery near-term and the Fed is unlikely to move in a more hawkish direction until they see a more significant rebound. Unfortunately, the Fed still does not want to clarify when it thinks the labour market recovery is well underway. While Friday's jobs report was weaker than anticipated, we think it is worth noting that employment in "Leisure and hospitality", the sector hit the hardest by the pandemic, rose more than what we normally see in the beginning of the year due to the gradual easing of restrictions.

Last week, Fed chair Powell said that *"The economic outlook here in the United States has clearly brightened"* but "hat *"it has been slower for those in lower paid jobs"* noting that 20% of workers in the lowest earnings rung were still unemployed a year after the start of the pandemic (6% for the highest-paid workers).

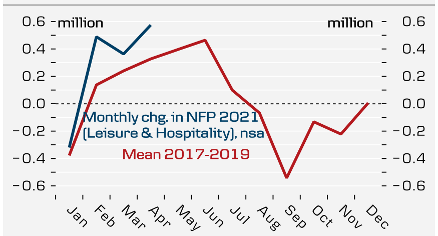
In his speech *"The Economic Recovery: Are we there yet?"*, 3 May, NY Fed President John Williams had some interesting reflections worth noticing. First of all, he said that *"While I am optimistic that the economy is now headed in the right direction, we still have a long way to go to achieve a robust and full economic recovery"*. Williams said that he likes to look at the employment-to-population ratio, which remains more than 3pp below the pre-pandemic level in February 2020. Therefore, the US economy *"needs big jobs numbers for some time"* to get back on its feet. Also Cleveland Fed President Loretta Mester and Minneapolis Fed President Neel Kashkari highlighted the big unemployment gap last week.

5yr US Treasury yields are now trading below 0.80%



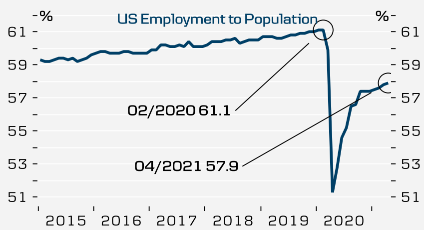
Note: Past performance is not a reliable indicator of current or future results.
Sources: Federal Reserve, Bloomberg, Macrobond Financial

Employment in Leisure and Hospitality has risen more than normal in the beginning of the year



Sources: BLS, Macrobond financial

NY Fed President likes to look at the employment-to-population ratio, which remains subdued



Sources: BLS, Macrobond financial

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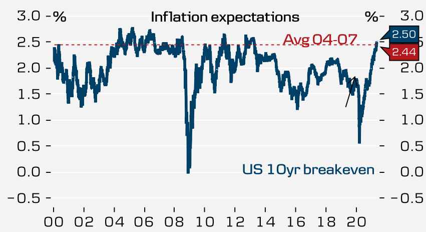
In an interview with CNBC, Fed Vice Chair Richard Clarida said that *"We're still a long way away from our goals"* but added that *"as we go through the year and we assess that data, we'll be able to make judgment about substantial progress"*. NY Fed President Williams said that *"the data and conditions we are seeing now are not nearly enough for the FOMC to shift its monetary policy stance"*. **Both quotes highlight that the Fed is indeed outcome-based (or, to be more precise, employment-based near-term).** Chicago Fed President Charles Evans said that he is *"not in a hurry"* having a discussion about when the Fed should start tapering. Boston Fed President Eric Rosengren indicated that he also thinks that it is premature focusing on tapering but added that *"it is quite possible that we will see those conditions ("substantial progress"), as we get to the end of the year"*. **So there are also indications that the Fed will take stock later in the year.**

At the moment, Dallas Fed President Robert Kaplan is the most hawkish FOMC member saying that he would like to *"begin discussions about how to taper sooner rather than later"*, as he expects to see substantial progress sooner than we he previously expected. Very interestingly, he also hinted that the Fed may hike rates while tapering, something which is not consensus right now with the Fed signalling that QE bond buying needs to end before hiking rates. Kaplan's views are, as explained, clearly not shared by his fellow Fed colleagues. -

Near-term, this also means that volatility around jobs report should be larger than previously, as the labour market recovery is key for the Fed's decision on when to start tapering. One thing to look out for is whether there are supply issues near-term, as some workers earn more on unemployment benefits than by working. The temporarily higher unemployment benefits expire on 6 September. **That said, there are two conflicting forces, as higher inflation has clearly become a bigger concern for investors recently.** This was also what we saw on Friday.

US 10yr breakeven inflation back to where it is supposed to be



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Sources: Bloomberg, Macrobond Financial

Inflation: Higher inflation is temporary

On inflation, NY Fed President Williams said that he expects inflation to run above 2% for the rest of the year but come back to *"about 2%"* next year, when *"price reversals and short-run imbalances from the economy reopening have played out"*. Williams also highlighted that the pre-pandemic economy was a "tight labour market, low inflation" economy (our own phrase). Cleveland Fed President Loretta Mester said that higher inflation this year, according to her expectation, would not be *"the type of sustainable increase needed to meet the forward guidance on our policy rate"*. Fed Vice Chair Richard Clarida has previously said he will look at inflation in Q4 to judge whether inflation has risen on a more sustained basis.

Financial stability: Other tools available to deal with financial stability risks and excessive risk taking

There have been a lot of discussions about elevated asset prices, not least with the release of the *Fed's semi-annual financial stability* report stating that some asset valuations are *"elevated relative to historical norms"* and *"may be vulnerable to significant declines should risk appetite fall"*.. NY Fed President Williams have said that the development so far is not like what we saw ahead of the financial crisis and that *"issues around asset prices and **financial stability [is] primarily in the realm of our regulation and supervision of financial institutions"*.** **This indicates that rates will remain low and the Fed believes it has better tools for dealing with excessive risk taking if necessary down the road than raising rates.**

This week: Do not expect the Fed to change tone near-term

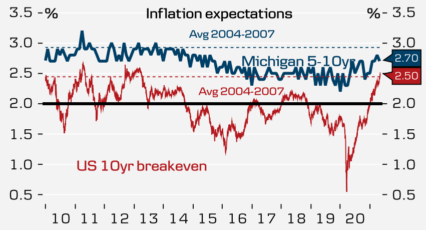
We do not expect the FOMC members to change rhetoric near-term. The Fed has made it crystal clear that it is outcome-based and the Fed is just waiting for data to come in before moving in a more hawkish direction. That said, several FOMC members are speaking this week.

Today, Chicago Fed President Charles Evans discusses the economic outlook. Tomorrow, we have Williams, Brainard, Daly, Bostic, Harker and Kashkari out talking. On Wednesday, we are very interested in Fed Vice Chair Richard Clarida's speech on the economic outlook. On Thursday, Barkin, Waller and Bullard are speaking and on Friday it is Kaplan's turn.

This week's most important data release is CPI inflation data for April on Wednesday, where headline inflation is likely to move above 3.5% y/y, partly because of base effects. **We are more interested in CPI core, which rose +0.3% m/m in March, which we did not see many times during the expansion after the financial crisis. Another +0.3% m/m print may lead to a comeback to inflation scares**. It is also worth noting that US 10yr breakeven inflation rates are now at 2.5%, which is basically the level prevailing before the financial crisis and too low inflation and the effective lower bound became a problem. The Fed also recognised this at the latest meeting. Consumer-based measures are still a bit too low.

Consensus is looking for another increase in retail sales in April, which is due out on Friday. However, do not be surprised if we see a setback, as retail sales in March was extremely strong, supported by a combination of the gradual easing of restrictions and not least the third stimulus check.

Survey-based inflation expectations can still move a bit higher



Note: Past performance is not a reliable indicator of current or future results.

Sources: Michigan, Bloomberg, Macrobond Financial, Danske Bank

Current Fed call and market pricing: Fed to turn more hawkish in September

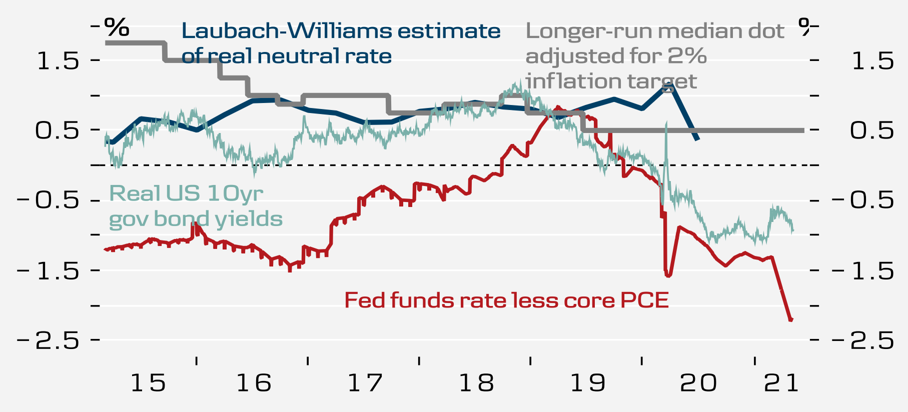
We expect the labour market recovery to be fairly strong this year meaning that the Fed is likely to turn more hawkish in September, where we expect the initial discussions on tapering to start. We expect the Fed will start talking more seriously about tapering in Q4 21 so that actual tapering can start in January 2022. We expect the Fed to taper USD20bn per meeting implying that tapering will conclude in September 2022.

We expect the Federal Reserve to hike the first time in the first half of 2023, probably already in Q1.

After the weak jobs report for May, we do not expect the Fed to change rhetoric already at the June meeting but we could see a shift in July or more realistically in September.

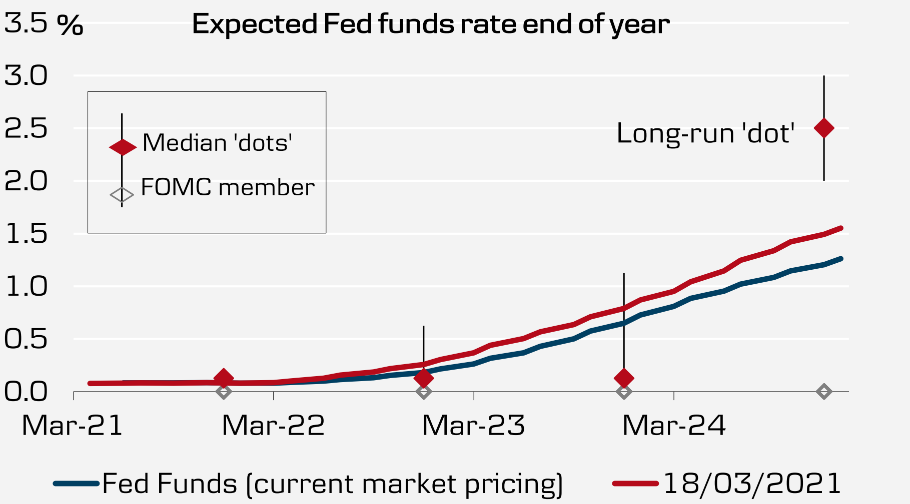
Fed charts

Monetary policy is still accommodative and real rates have declined

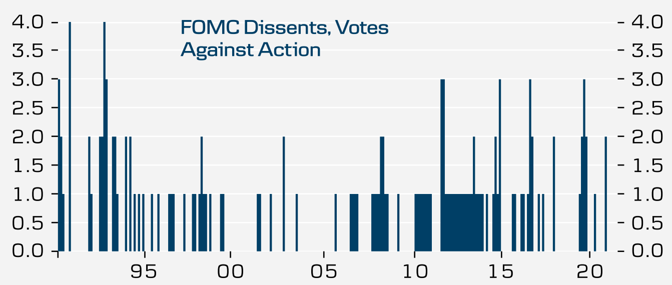


Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

Investors are now pricing in the first full 25bp hike in Q2 2023

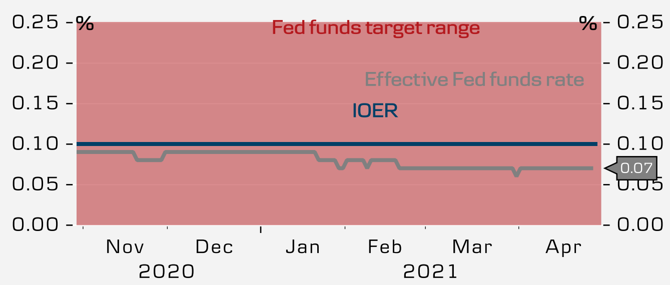


The FOMC members usually work by consensus



Source: St Louis Fed, Macrobond Financial, Danske Bank

The Fed may hike the IOER rate soon, as the effective Fed funds rate remains to the low side



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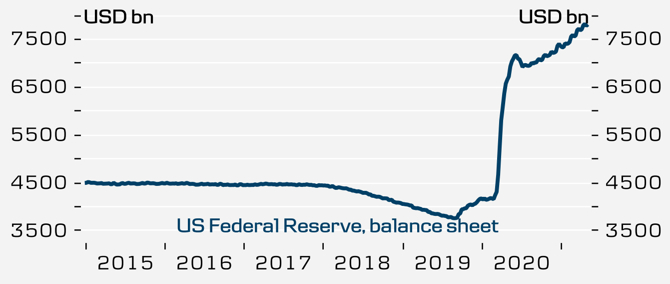
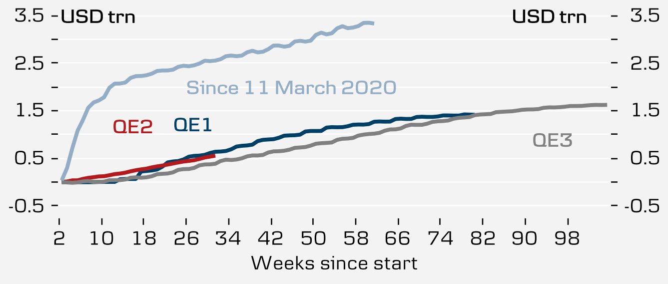
Source: Federal Reserve, Macrobond Financial, Danske Bank

US balance sheet has been increasing rapidly



Source: Federal Reserve, Macrobond Financial, Danske Bank

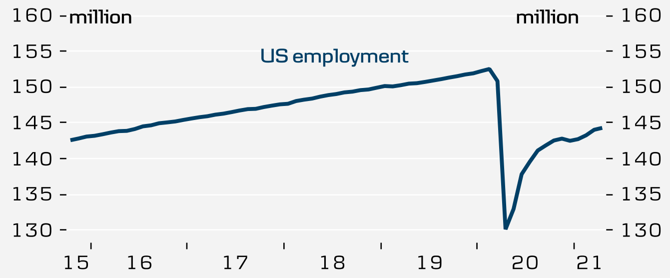
Fed buying USD120bn worth of bonds per month



Sources: Federal Reserve, Macrobond Financial

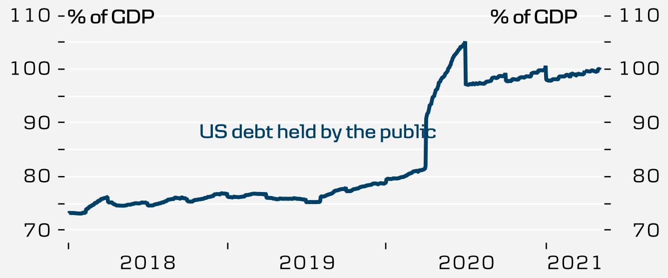
Macro charts

Employment remains significantly below pre-corona levels



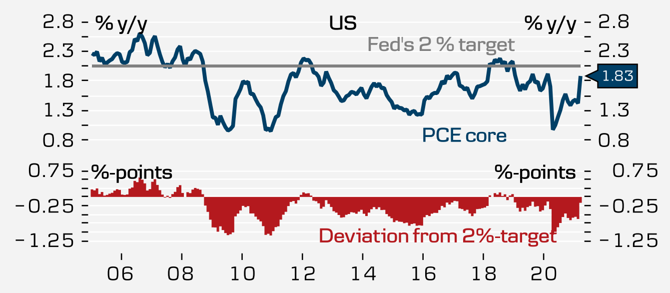
Source: BLS, Macrobond Financial, Danske Bank

US debt to increase further due to Biden's relief package



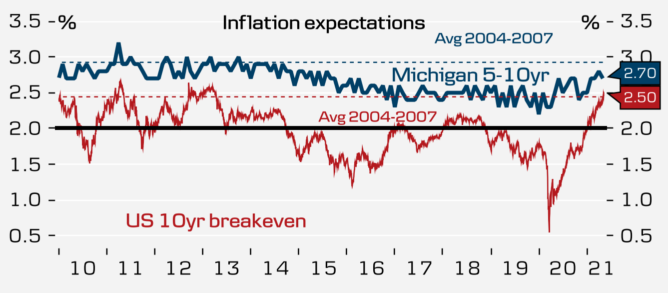
Sources: US Treasury, Federal Reserve, Macrobond Financial

PCE core inflation remains below by 2% but is likely to move above in April



Source: BEA, Macrobond Financial, Danske Bank

US 10yr breakeven inflation rate is back to where it is supposed to be



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