30 November 2021

# Fed Research

## Say farewell to team transitory - tightening sooner and faster

### Key takeaways

- We are changing our Fed call based on Fed Chair Powell's comments today and yesterday, which were definitely strong hawkish signals. Powell argues that COVID-19 outbreaks are inflationary, that it is time to *"retire"* the word transitory and that the Fed can consider ending QE bond buying *"a few months"* earlier.
- We now expect the Fed to increase the tapering pace from USD15bn per month to USD25bn so that the tapering is concluded in April (from June previously). We have been arguing that risks were skewed towards a faster tapering pace.
- We now expect three 25bp rate hikes in 2022 in June, September and December. By ending QE bond buying in April, the door is open for the first rate hike in May. We still expect four rate hikes in 2023.
- If the Fed increase the tapering pace to USD30bn, it would be a strong signal, in our view, that the first rate hike may arrive as early as in March, as the Fed has made it clear that it would like to end QE bond buying before hiking interest rates.
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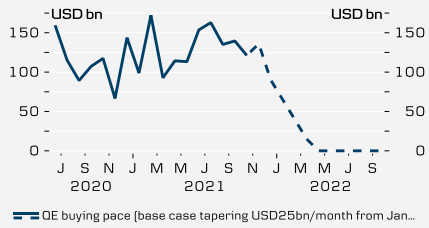
### Fed call: Powell U-turn

We believe Fed Chair Jerome Powell's comments today and yesterday mark a policy U-turn. Powell highlights some very important things

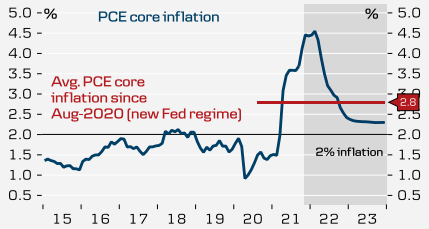
- COVID-19 outbreaks are inflationary in nature, as they *"reduce people's willingness to work"* causing a prolonged period with supply-chain disruption. We have been arguing for a while that it also adds to the inflationary pressure by keeping goods consumption elevated. A new outbreak in the US is now ongoing and the omicron probably adds to uncertainty.
- CPI inflation reached 6.2% y/y in October, the highest in more than 30 years, and long-term inflation expectations from the University of Michigan consumer survey are now 3.0%, which is above the 2004-2007 average. These, together with high wage pressure, are likely the reason why Powell said that it is time to *"retire"* the transitory term.
- Fed Chair Powell said *"it is therefore appropriate, in my view, to consider wrapping up the taper of our asset purchases, perhaps a few months sooner"*, clearly a hawkish shift from earlier this year when Powell was not "thinking about thinking about" tightening monetary policy. We know the Fed likes to work by consensus and even more dovish-to-neutral members like Clarida and Daly have argued that along the same lines.

**QE bond buying to end in April with an increase in the tapering pace to USD25bn per month**



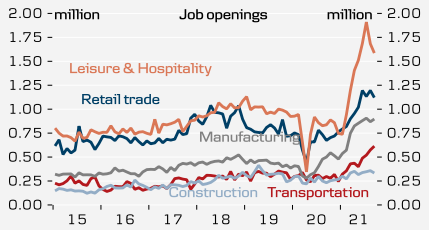

*Sources: Federal Reserve, Macrobond Financial, Danske Bank illustration*

**PCE core inflation likely to remain above 2% in coming years**




*Sources: BEA, Macrobond Financial, Danske Bank forecasts*

**Supply side problems? Labour demand is high**




*Sources: BLS, Macrobond Financial*

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The Fed was worried that markets would react very negatively to a tightening bias, not least a repetition of the taper tantrum in 2013, but that has not materialised. For that reason the Fed is likely more confident increasing the tapering pace. At the recent meeting, Fed Chair Jerome Powell argued that tapering was not a signal about the timing of rate hikes but in our view an increase in the tapering pace is definitely a sign that the Fed thinks it is time to tighten sooner and faster than previously (although the Fed has turned increasingly hawkish over the course of this year).

The jobs report on Friday and the CPI inflation print for November due out on 10 December are key for what the Fed is eventually going to do. We expect another strong jobs report with employment growth of around 500,000 and that CPI inflation rose from 6.2% to 6.5% in November with inflation likely remaining above 2% over the coming years. This would make the unemployment-inflation trade-off even worse from a Fed perspective, also knowing that inflation expectations and wage growth are already high. It is also clear that the labour market is already very hot by many measures and it likely takes much longer before people return, also now with rising new cases in the US. This means that potential output has likely declined more than the Fed acknowledges previously. We feared that the Fed was getting behind the curve but with the recent U-turn, we think the Fed is in a better situation to control the rising inflation risks.

We expect the Fed to increase the tapering to USD25bn per month starting from January, which should be a suitable compromise between doves and hawks, as we know the Fed likes to work by consensus. This would end QE bond buying in April.

The end of QE bond buying also means that the Fed can start a "normal" hiking cycle hiking at every other meeting (once per quarter). We expect the Fed to hike three times in 2022 (in June, September and December). By ending bond buying already in April, the door is open for a rate hike already in May. If we are wrong and the Fed increases the tapering pace to USD30bn per month, the door is open for a rate hike as early as in March.

We still expect the Fed to hike four times in 2023.

**Our Fed call summarised**

In line with our call, the Fed started tapering QE bond buying by USD15bn per month at the November meeting but since then the Fed has moved in a more hawkish direction (which has been the case over the course of the year), latest with Fed Chair Jerome Powell's comments on rising inflation risks and that inflation is probably not as transitory as previously thought.

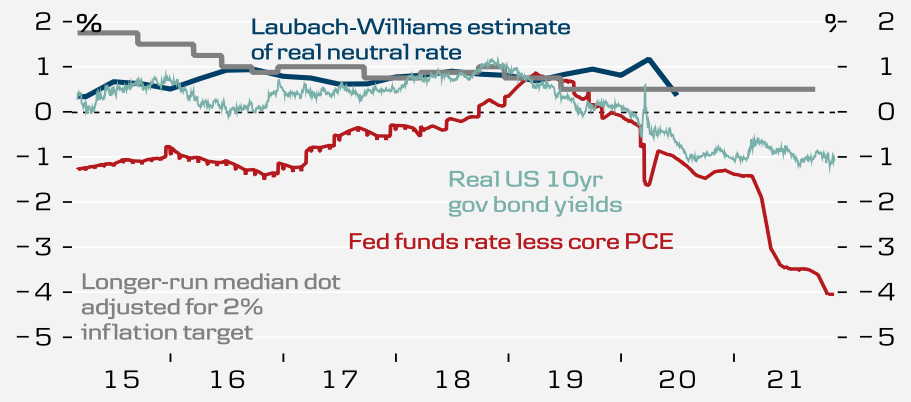
As a consequence, we now believe the Fed will increase the tapering pace to USD25bn per month starting from January, implying an end to QE bond buying in April.

We now expect the Fed to hike three times 2022 (June, September and December). If we are right about the increase in the tapering pace, the door is open for a rate hike at the May meeting.

If the Fed increases the tapering pace to USD30bn per month, the Fed may raise the Fed funds target range already in March.

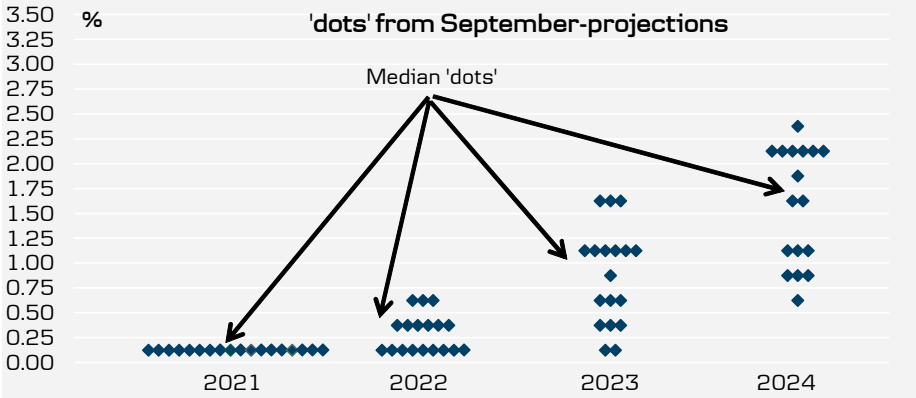
## Fed charts

**Monetary policy is still accommodative**



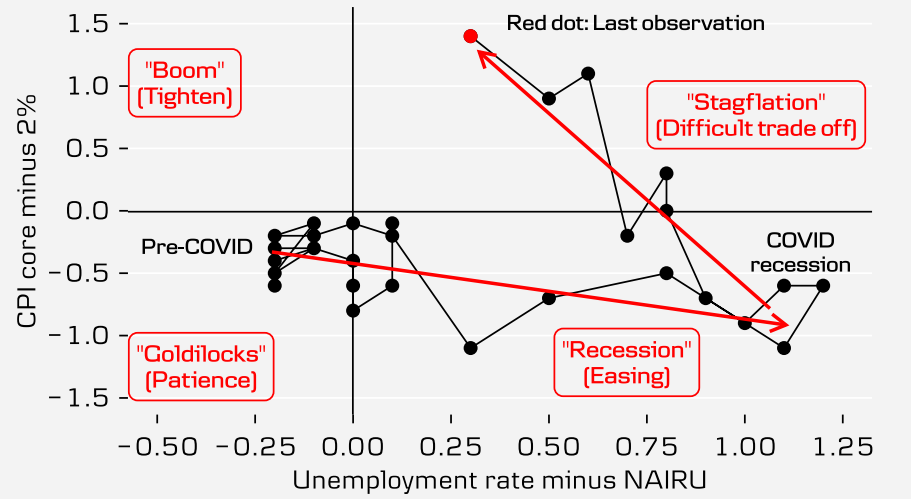

*Note: Past performance is not a reliable indicator of current or future results.*
*Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank*

**Fed dot plot from September**



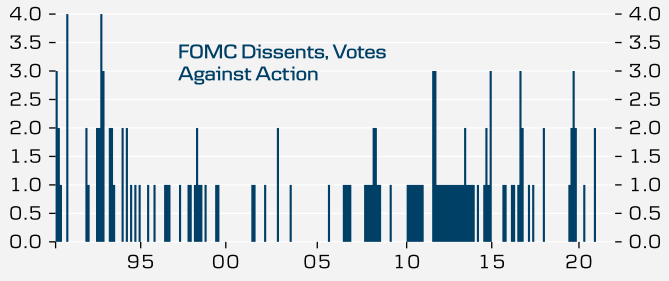

*Sources: Federal Reserve, Danske Bank*

**Fed's trade-off**



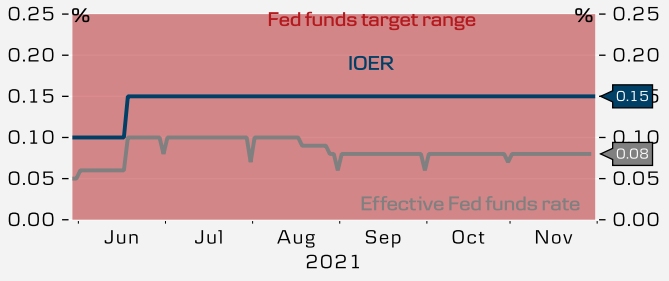

*Sources: BEA, Macrobond Financial, Danske Bank illustration*

### The FOMC members usually work by consensus




*Source: St Louis Fed, Macrobond Financial, Danske Bank*

### Effective Fed funds rate unchanged at 8bp

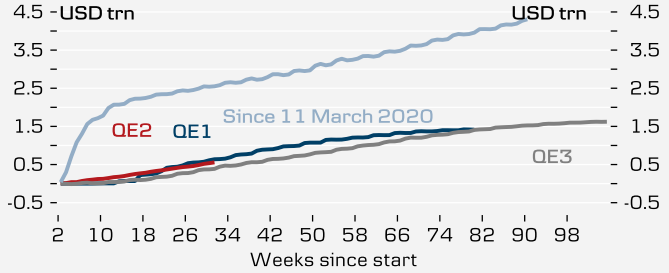



*Note: Past performance is not a reliable indicator of current or future results.*
*Source: Federal Reserve, Macrobond Financial, Danske Bank*

### US balance sheet has been increasing rapidly due to QE


*Source: Federal Reserve, Macrobond Financial, Danske Bank*

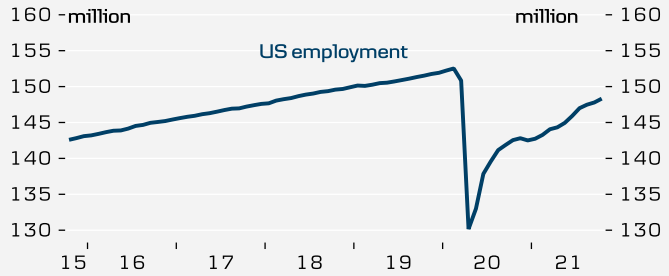
### Fed has started the process of concluding QE bond buying




*Sources: Federal Reserve, Macrobond Financial*

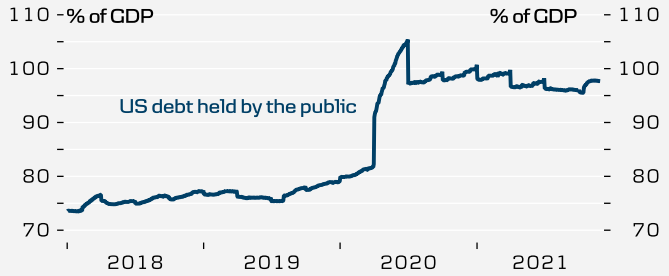
## Macro charts

### Employment remains significantly below pre-corona levels but jobs indicators are overall strong



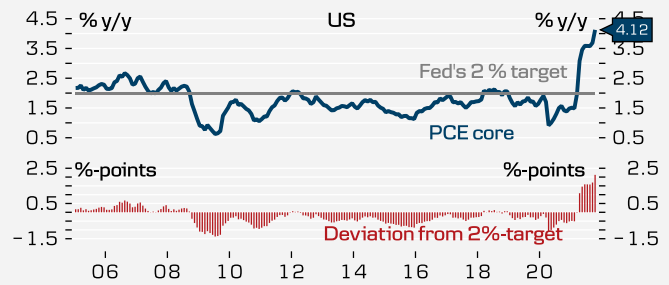

*Source: BLS, Macrobond Financial, Danske Bank*

### US debt has been quite stable since the increase in the early days of the pandemic



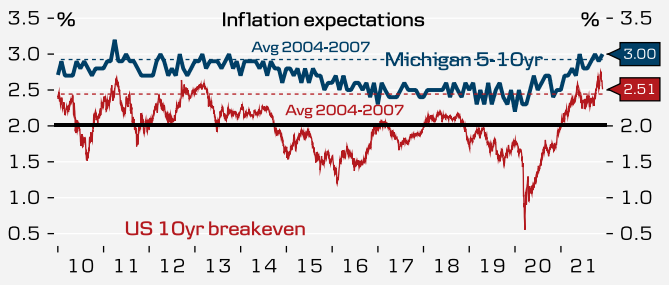

*Sources: US Treasury, Federal Reserve, Macrobond Financial*

### Very high PCE inflation




*Source: BEA, Macrobond Financial, Danske Bank*

### Long-term inflation expectations (University of Michigan) now above the 2004-2007 average




*Note: Past performance is not a reliable indicator of current or future results.*
*Source: Michigan, Bloomberg, Macrobond Financial, Danske Bank*

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