Danske Bank

28 July 2021

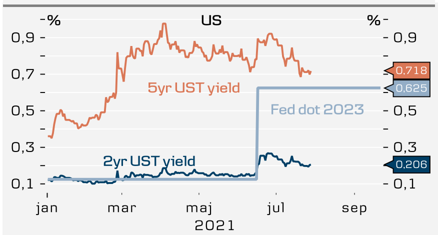
Fed Research

Review: Another step towards less accommodative monetary policy

Key takeaways

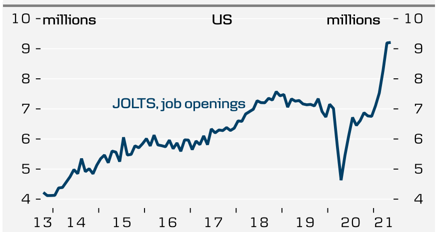
- Like in June, the Fed was more hawkish than anticipated at the July meeting. The Fed now says that *"the economy has made progress towards"* the goals and that the Fed *"will continue to assess progress in coming meetings"*. It was one of the interim meetings without updated projections and new dots.
- The Fed repeats that high inflation is *"largely reflecting transitory factors"* (Fed Chair Jerome Powell repeated that the Fed still expects inflation to moderate and that high inflation is tied to a handful of categories during the press conference), so the change of tone is likely due to the improvement in the labour market (not just nonfarm payrolls but also other indicators like job openings).
- That said, Fed Chair Jerome Powell said that the labour market recovery still *"has a ways to go"* during the press conference. So the labour market remains key for the timing of less accommodative monetary policy.
- The Fed says that *"the sectors most adversely affected by the pandemic have shown improvement but have not fully recovered"*. Since the June meeting, the Fed has removed the comments that these sectors "remain weak".
- Basically, the Fed continues moving closer to making monetary policy less accommodative. Fed Chair Jerome Powell repeated that the timing depends on data (and is not pre-determined) and overall Powell sent a less hawkish signal during the press conference than the statement, also saying that the first rate hike is still far away. This may indicate that disagreements within the FOMC are growing. Markets turned around during Powell's press conference.
- We continue to expect that the Fed will turn more and more hawkish in coming months so that actual tapering will start in Q4. We think it is too early for the Fed to make the next change in connection with the Jackson Hole (also given Fed Chair Powell's more dovish comments during the press conference) but think the September meeting is more likely (two jobs reports away). We expect tapering is concluded in summer 2022. We expect the first rate hike in H 2022. For more details see next page.

US yields unchanged after the meeting



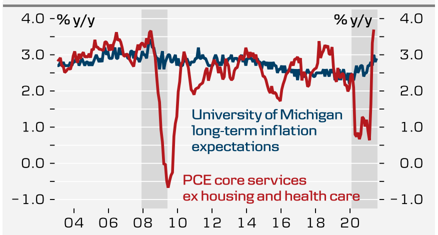
Note: Past performance is not a reliable indicator of current or future results.
Sources: Federal Reserve, Bloomberg, Macrobond Financial

Still more hawkish signal due to strong labour market indicators including record-high number of job openings



Sources: JOLTS, Macrobond financial

Fed not overly concerned about high inflation due to well-anchored expectations



Sources: BEA, University of Michigan, Macrobond financial

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Our Fed call

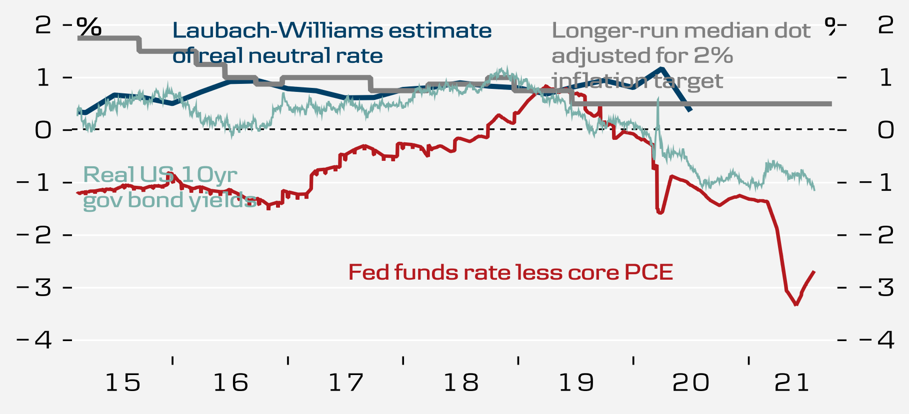
We continue to expect that the Fed will turn more and more hawkish in coming months so that actual tapering will start in Q4. We think it is too early for the Fed to make the next change in connection with the Jackson Hole (also given Fed Chair Powell's more dovish comments during the press conference) but think the September meeting is more likely (two jobs reports away). We are not surprised if the tapering is faster in mortgage-backed securities than treasuries given the development in the housing market, however Powell said that the Fed expects the tapering pace will be the same. We expect tapering is concluded in summer 2022.

We expect the first rate hike in H 2022.

Overall, we see a road from here with tapering, rate hikes and a mild liquidity tightening in coming years.

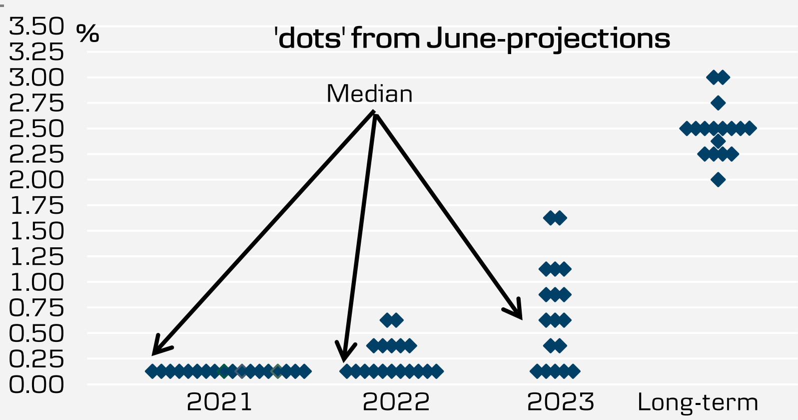
Fed charts

Monetary policy is still accommodative



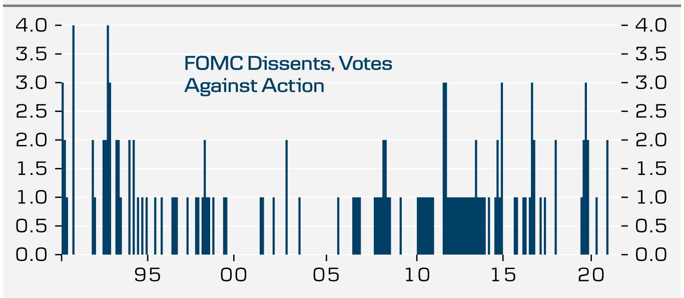
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

Fed dot plot from June



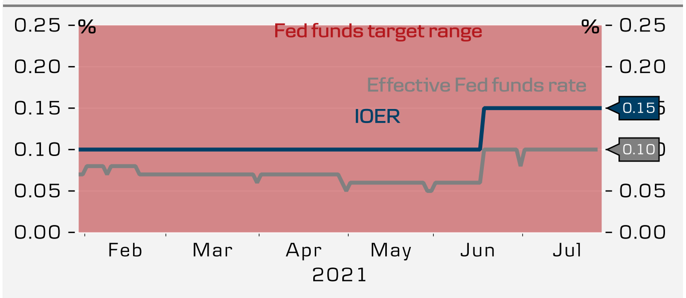
Sources: Federal Reserve, Danske Bank

The FOMC members usually work by consensus



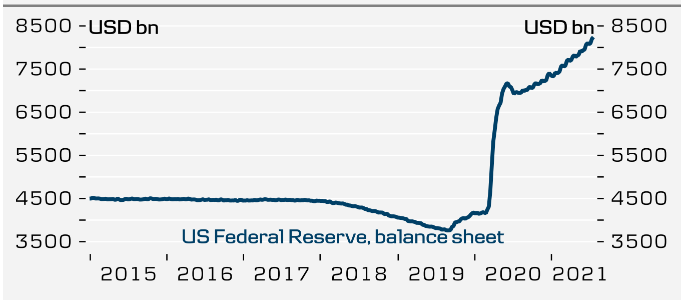
Source: St Louis Fed, Macrobond Financial, Danske Bank

Effective Fed funds rate rose after the IOER rate hike in June



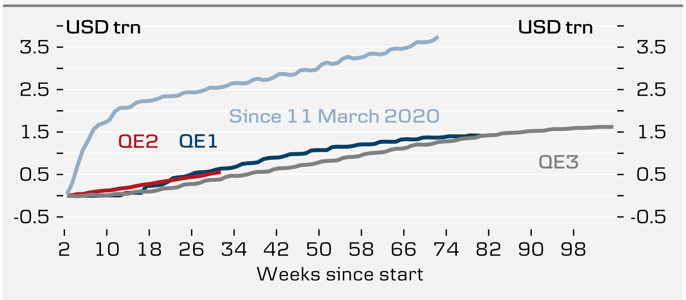
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Macrobond Financial, Danske Bank

US balance sheet has been increasing rapidly



Source: Federal Reserve, Macrobond Financial, Danske Bank

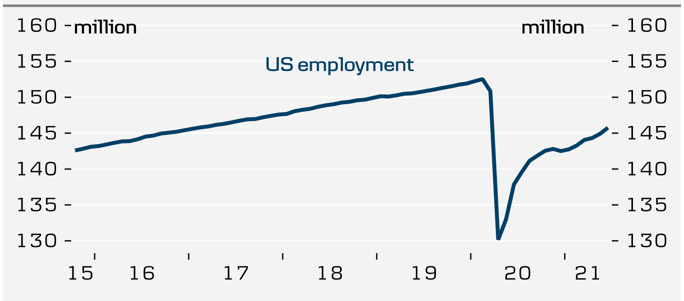
Fed is still buying USD120bn worth of bonds per month



Sources: Federal Reserve, Macrobond Financial

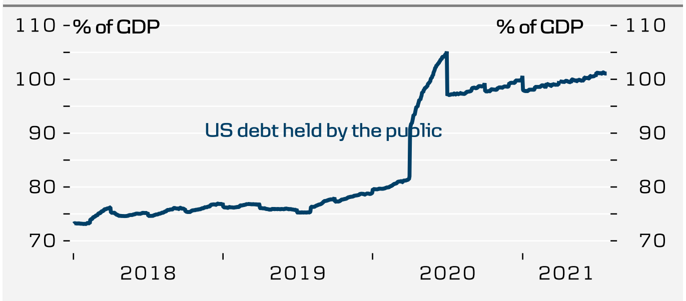
Macro charts

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



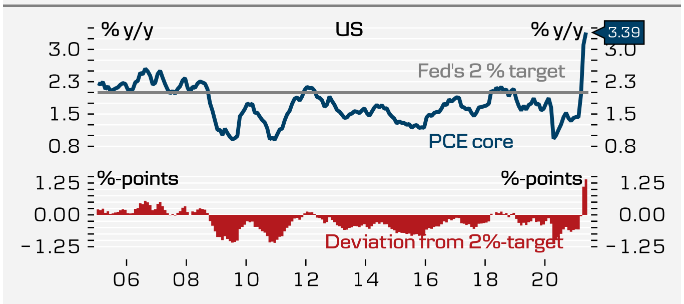
Source: BLS, Macrobond Financial, Danske Bank

US debt to increase further



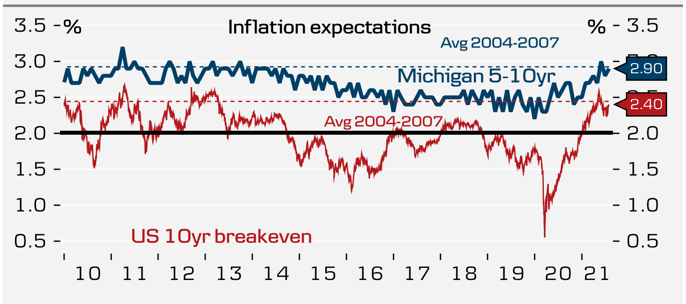
Sources: US Treasury, Federal Reserve, Macrobond Financial

PCE core inflation has moved sharply higher but the Fed expects it to moderate



Source: BEA, Macrobond Financial, Danske Bank

Inflation expectations have risen since 2020 but remain well-anchored



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

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report is Mikael Olai Milhøj, Chief Analyst.

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Ad hoc.

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