Economics

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FOMC Says That Tapering "May Soon Be Warranted"

Summary

- As widely expected, the Federal Open Market Committee (FOMC) voted unanimously today to keep the target range for the fed funds rate unchanged at 0.00% to 0.25%.
- The Committee also decided to keep its monthly pace of asset purchases unchanged at $80 billion of Treasury securities and $40 billion of mortgage-backed securities. However, the FOMC said that tapering "may soon be warranted."
- In our view, the commencement of tapering could be announced at the next FOMC meeting on November 3. If payrolls in September rebound from their disappointing 235K increase in August, then the Committee could very well decide that the conditions to begin tapering have been met.
- Chair Powell suggested in his post-meeting press conference that the Fed could wrap up its asset purchases by the middle of next year, which would be a faster pace of tapering than in 2014.
- The FOMC pared back its GDP growth forecast for this year, but boosted its outlook for next year.
- The "dot plot" now has nine members looking for a rate hike by the end of next year, which is up from seven members in June. But the commencement of tapering, should it begin in November, does not indicate that rate hikes are around the corner. Most Committee members would want to see the economy return to "maximum" employment before hiking rates.

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Will Tapering Commence in November?

In a widely anticipated meeting that concluded today, the FOMC did not make any major policy changes, which was expected by most market participants. The Committee maintained its target range for the federal funds rate at 0.00% to 0.25%, and it left its monthly pace of asset purchases—$80 billion of Treasury securities and $40 billion of mortgage-backed securities (MBS)—unchanged as well. These decisions were unanimously supported by all 11 voting members of the FOMC.

But the meeting was widely anticipated because some market participants were expecting that the Committee would announce the commencement of "tapering" of the Fed's asset purchases, or some hints about the possible timing of tapering. In that regard, the FOMC reiterated its line from the July 28 meeting that "progress" has been made toward meeting the Committee's goals of "maximum" employment and "inflation at the rate of 2 percent over the longer run." But it went on to say in today's statement that "if progress continues broadly as expected, the Committee judges that a moderation in the pace of asset purchases may soon be warranted."

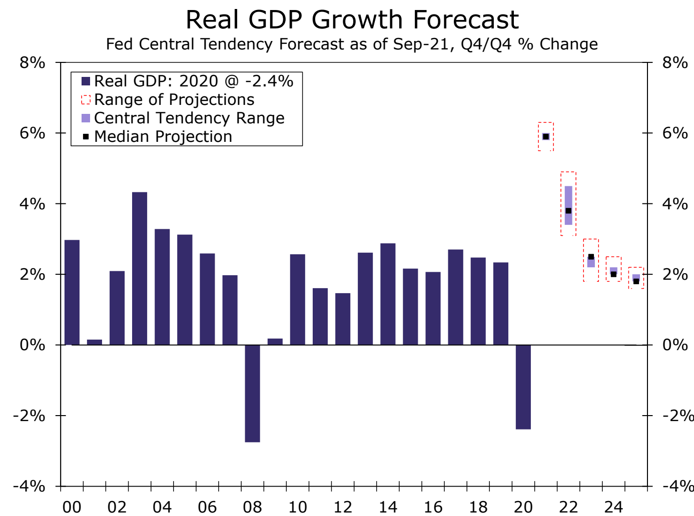
This sets up the FOMC to potentially announce the commencement of tapering at the next FOMC meeting on November 3. In our view, that decision will ultimately depend on the flow of data, and the course of the pandemic, over the next few weeks. In that regard, the Committee did note that "the sectors most adversely affected by the pandemic have improved in recent months, but the rise in COVID-19 cases has slowed their recovery."

In our view, the September labor market report, which is scheduled for release on October 8, will be crucial in determining whether the FOMC will announce a tapering decision at its next meeting. If payrolls rebound from their disappointing increase of only 235K in August, then the Committee may feel that the commencement of tapering is appropriate. However, if payrolls disappoint again, then the FOMC may decide to take a pass at the November meeting and wait until its last meeting of the year on December 15 to see if the data improve by then. We are clearly back in "data dependency" mode.

It took the Fed the entire year of 2014 to wind down its last episode of asset purchases. Tapering may progress more quickly this time because the economy arguably is stronger today than it was in 2014. In addition, the inflation rate is higher today than it was seven years ago. Notably, Chair Powell suggested in his post-meeting press conference that the Committee may want to wrap up its asset purchases by the middle of next year.

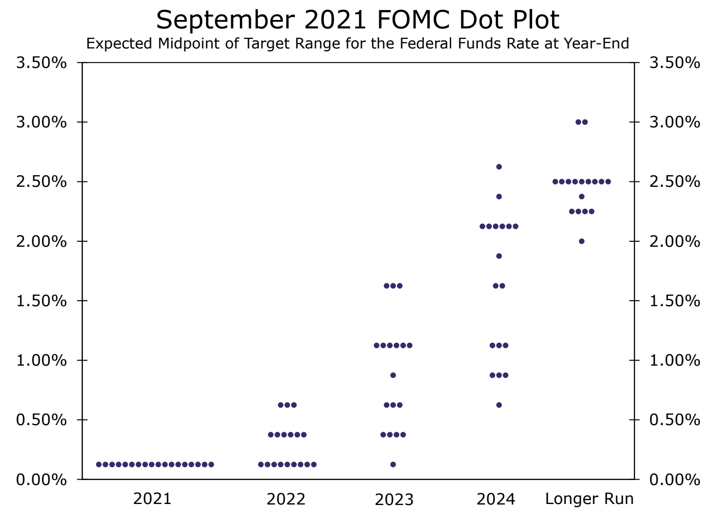
The FOMC also made some changes to its macroeconomic forecasts in its quarterly Summary of Economic Projections (SEP). Specifically, the median forecast looks for real GDP to grow 5.9% this year, which is a notable downshift from the 7.0% rate that was reported in June (Figure 1). Additionally, the median forecast looks for the unemployment rate to end this year at 4.8%, up from the 4.5% rate that was projected in June. The dialing back in the pace of economic growth likely is due to the growth outturn for the second quarter, which was not as strong as expected, and the resurgence of COVID over the past few months, which has caused growth to downshift a bit. However, the Committee sees the lost ground being made up next year. Specifically, the median GDP growth forecast for 2022 was raised to 3.8%, up from the 3.3% rate that was forecasted in June.

Figure 1



Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Securities

Figure 2



Source: Federal Reserve Board and Wells Fargo Securities

In addition, there were some changes to the "dot plot," which shows each committee member's expectations about the level of the fed funds rate in coming years. In June, 7 of the 18 committee members thought that the fed funds rate would be higher than its current range of 0.00% to 0.25% at the end of next year. The dot plot that was released today now has the Committee evenly split (nine to nine) on the outlook for higher rates at the end of next year (Figure 2). Only one member now sees the fed funds rate remaining unchanged through the end of 2023—there were five members in June—with the median looking for 75 bps of rate hikes by the end of 2023. Every member thinks that rates will be higher by the end of 2024.

Although the commencement of tapering "may soon be warranted," Fed officials have stressed that its kickoff does not imply that rate hikes are imminent. For example, Fed Chair Powell said in his Jackson Hole speech in August that "the timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test." The FOMC wants to see employment returning to its "maximum" level before it begins to raise interest rates and, according to Powell, "we have much ground to cover to reach maximum employment." The fact that all 18 members do not see the Fed hiking rates this year and that nine members think that rate hikes may not be appropriate through the end of next year indicates that the Fed will not be tightening policy anytime soon. We continue to forecast that the Fed will remain on hold through the end of next year. Although we look for 75 bps of rate hikes in 2023, we forecast that they all will occur in the second half of the year.

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