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Global Fixed Income Strategy Bulletin

Federal Reserve signals monetary accommodation wind-down announcement “this year”, but specific date uncertain

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Background:

- The Federal Reserve held their Jackson Hole Economic Policy Symposium, entitled “Macroeconomic Policy in an Uneven Economy” today. This year’s symposium is virtual due to concerns over COVID-19.
- The most important speech was by Chairman Powell, when he delivered opening remarks to kick-off the event. Markets had anticipated this speech for months now in expectation of getting a signal about the start date of a gradual reduction, or “taper”, of the Fed’s $120bn in net new monthly Treasury and MBS purchases (known as Quantitative Easing, or “QE”).
- The taper start date – and monthly pace of that taper down to zero – is important since market participants expected that the Fed will not raise rates until sometime after the taper is finished.

Announcement summary

- Powell’s remarks were released at 10am EST, and while markets are currently digesting the full content, it appears that Powell signaled that a formal taper announcement will occur this year, but he left the formal announcement date open, saying that it “*could be appropriate to begin tapering this year*”.
- The Fed has a dual mandate of stable pricing (currently interpreted as a sustainable average inflation target of slightly above 2%) and maximum employment, and many FOMC participants have expressed in recent days their belief that the inflation target has been met, while the employment mandate will be met soon.
- Chairman Powell agreed with other FOMC members on inflation, stating that the “*substantial further progress test met for inflation*”, though he thinks inflation is mostly transitory, and he thinks more time is needed to judge whether the labor market has fully recovered, saying “*much ground to cover to reach maximum employment*” (in part due to risks of the COVID-19 Delta variant).
- Powell also indicated that the timing of rate hikes is not necessarily dependent on the tapering timeline.
- Below are several key points from his speech which summarize his overall views:
    - ***“If a central bank tightens policy in response to factors that turn out to be temporary, the main policy effects are likely to arrive after the need has passed. The ill-timed policy move unnecessarily slows hiring and other economic activity and pushes inflation lower than desired. Today, with substantial slack remaining in the labor market and the pandemic continuing, such a mistake could be particularly harmful.”***

- *"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. We have said that we will continue to hold the target range for the federal funds rate at its current level until the economy reaches conditions consistent with **maximum employment**, and inflation has reached 2 percent and is on track to moderately exceed 2 percent for some time. **We have much ground to cover to reach maximum employment, and time will tell whether we have reached 2 percent inflation on a sustainable basis.***

Our takeaway:

This was a somewhat dovish speech, but only by a few months, as it likely pushed the formal taper announcement from September to November as the Fed awaits more employment data, with the actual taper itself probably starting in December or January. Market consensus is still for $15bn reduction of purchases each month, resulting in an 8 month timeline to end-of-taper (ending in roughly July or August 2022). This timeline can of course be halted or adjusted (or even reversed) given the Fed's data-dependent approach, but barring a significant change in the economic trajectory and given the Fed's propensity to warn the market well in advance of major policy changes, we think this pace would be maintained if possible (COVID-19 impacts being the principal wildcard, as noted by Powell).

Once the Fed has finished its taper, it is likely to wait some amount of time before it then embarks on raising the Fed Funds policy rate just to make sure that the economy has not slowed down. This would put the first rate hike likely in early 2023 (in the last taper/rate hike cycle, then-Chairman Bernanke waited over a year after the taper was over in October 2014 before embarking on a cycle of rate hikes in December 2015). However, by starting to "delink" rate hikes from end-of-taper, Powell likely wants to maintain optionality on when the Fed can start a rate hike cycle in both cases of " inflation runs hotter than expected" OR waiting even longer than a few months to raise rates if "the economy is cooling".

The Treasury rates curve endorses this view, as rates had gone higher all week on expected Fed "hawkishness" that has now been pushed back in terms of timing. The market reaction to the speech was for rates to stay flat to slightly lower. Importantly, "real rates" have been trending higher somewhat from historically low levels, though the 10y real rate remains deeply negative at -1.00% as break-even inflation expectations hold steady at 2.35% **(see Figure 1)**. The 10y nominal yield needs to rise further over time to reduce this deeply negative "real yield", especially as inflation break-evens are unlikely to fall much in the near-term.

On the short end of the curve, the futures market is still pricing almost a full 25bps rate hike by December 2022, with about 2 more rate hikes by end of 2023. Looking further out, futures price the Fed Funds rate roughly above 1.50% by 2025 **(see Figure 2)**.

Figure 1: US 10yr TIPS yield vs Breakeven inflation rate

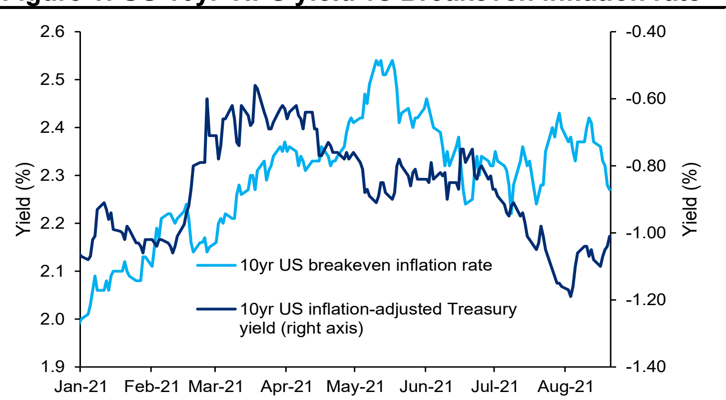
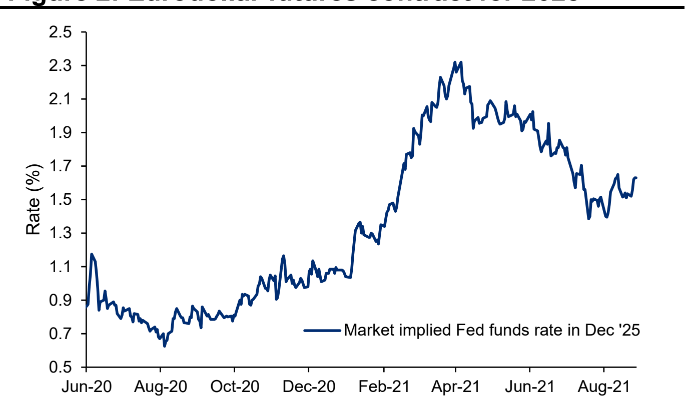


Figure 2: Eurodollar futures contract for 2025



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Overall, this announcement conforms with our view of the "end of easy money" (**An Early Call: The Beginning of the End of Easy Money**) as expected, however it will likely be very gradual, with some "real-time adjustments" in timing possible, particularly as the Fed starts raising rates. We think the Fed would ultimately like to see the 10y Treasury rate up to at least 2.5% over the next few years, and core consumer price inflation (CPI) near that, but those are medium-term goals. We note that the Fed's preferred measure is the core personal consumption expenditure index (PCE), which typically runs somewhat lower than core CPI, so that if these goals were achieved ultimately the 10y yield would be flat to slightly higher than inflation.

Federal Reserve balance sheet:

We have extensively detailed our view that in order for nominal yields to rise much higher, it is likely that the Fed needs to first start its taper. The combination this year of the Fed's monthly "QE", along with the reduction in the Treasury General Account ("TGA") by almost $2 trillion, have overwhelmed both the long-end and short-end of the market with additional demand. In this respect, a few pictures tell the story best on how large the Fed's balance sheet has grown, especially with respect to absorption of net new Treasury supply.

The Fed now owns over 25% of all marketable Treasury securities ($5.2tn out of $21tn), and a similar amount of the MBS market ($2.3tn out of $8.7tn). Notably, as the Fed's ownership of securities has been rising, so have US bank holdings, which receive additional deposits every month due to QE. Banks in turn must reinvest those deposits into something. Due to low loan growth, banks have increasingly used a portion of these excess deposits to purchase Treasuries and MBS for lack of any alternative **(see Figure 3)**. Indeed, in 2021, the Fed's QE has absorbed almost all net new Treasury supply (**see Figure 4**) even before bank purchases (and others such as foreign demand, pension funds, etc).

Figure 3: Fed and US Bank holdings of US Treasuries continue to gain share

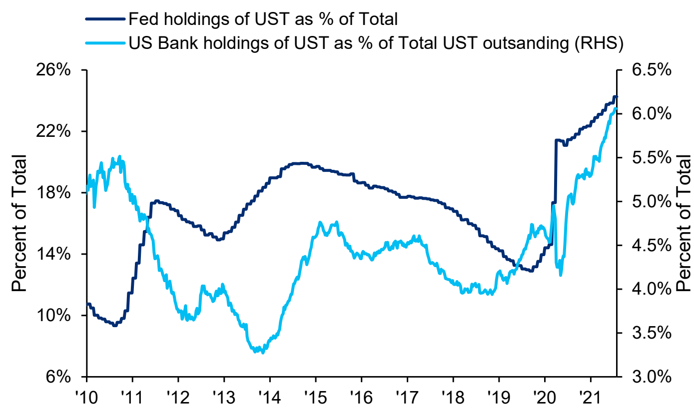
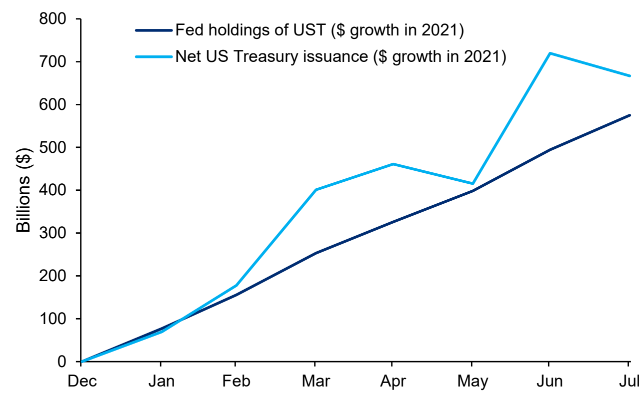


Figure 4: Cumulative net issuance vs Fed holdings of US Treasury bonds



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Once the Fed starts reducing its monthly QE, this "mechanical demand flow" for Treasuries should ease considerably, especially from banks who have been unable to deploy their growing deposits other than by buying securities or by depositing their excess cash at the Federal Reserve (a total of over $4 trillion in bank reserves is now deposited at the Fed – **see Figure 5**). On the very short-end of the yield curve, the TGA's reduction in cash balances -- in large part accomplished by redeeming T-bills - has caused money market funds and other traditional T-bill purchasers to also deposit their cash with the Fed in the Overnight Reverse Repo Program, which has now grown to over $1.1 trillion from zero at the start of April (**see Figure 6**).

As the Fed tapers, banks will continue to buy securities, but on the margin will likely wait for higher yield entry points before pulling their deposited cash out of the Federal Reserve (which currently earns 15bps as part of the IOER program) in order to invest in longer-duration bonds. Similarly, now that the TGA has reduced its cash balance well below what it would normally be due to the "debt ceiling" (see below), that "flow" of cash going out to the market should ultimately reverse as the TGA will need to build up its cash holdings again (by issuing more debt). However, given the amount of "dry powder" held by banks and money market funds, any rate rise is likely to be tempered, at least until demand for credit in the private sector starts increasing and "competing" with Treasuries for those excess reserves.

Figure 5: Fed's reserve balances

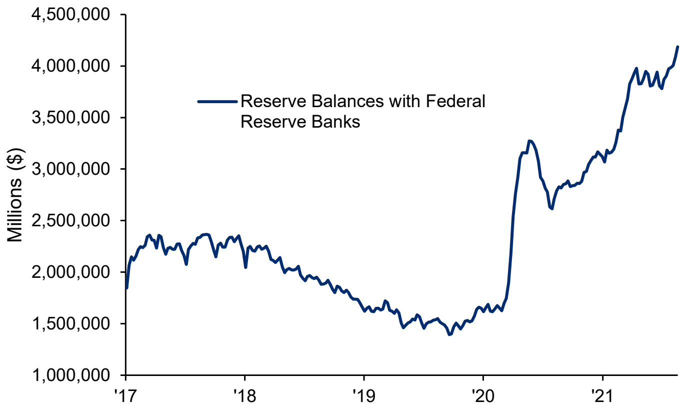
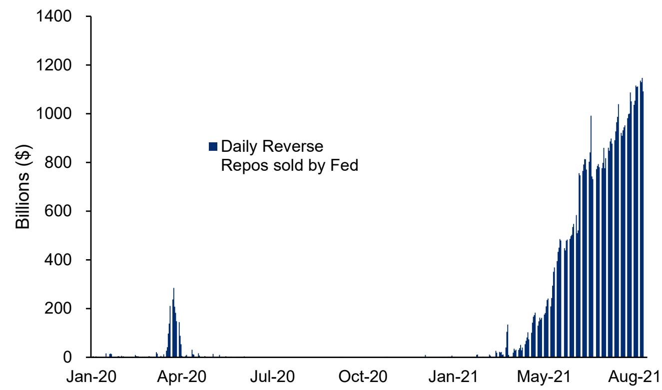


Figure 6: Reverse Repos sold by the Fed



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Debt ceiling/infrastructure bills:

One additional factor that may impact all of the above is potentially the infrastructure bills and debt ceiling, which are at this point becoming increasingly related as both political parties entrench **(see Infrastructure, Inflation and Interest Rates: Will Growth Prevail?).** While we believe that some amount of these bills will be passed, and some new taxes implemented to pay for at least a portion of the increased spending, it is unclear at this time how much will be passed and how much of that will be financed by new taxes. The additional deficit spending could be quite large, potentially $1 trillion or more (spread out over a number of years).

Should the Democrats pass some version of these bills without Republican support, which seems likely, the Republicans have – at least for now - vowed that they will not approve an increase to the debt ceiling, which was hit in August this year. In order to fund additional deficit spending, the Democrats would then need to increase the debt ceiling solely with votes from their party, which could make some of their more moderate membership politically vulnerable in the 2022 mid-term elections. Given that dynamic, it is possible that the infrastructure bills that are passed may be smaller than expected, or have more revenue increasing elements in order to bring Republican support to the debt ceiling or protect moderate Dem members if raising it is a strict party-line vote.

We expect that the Fed will be very sensitive to this dynamic as it tapers, and will not want to see a sudden rise in interest rates interjecting monetary policy considerations into these fiscal policy negotiations. So while we do see yields rising, this is yet another reason that we believe the rise will be gradual. Once the debt ceiling has been raised, the Treasury is likely to quickly replenish its TGA coffers with new debt issuance, which in turn should be supported by money-market fund purchases.

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