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Global Fixed Income Strategy Bulletin

Events in China upstage FOMC meeting; Federal Reserve indicates taper will begin soon

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Announcement summary:

- At their September meeting, the Federal Open Market Committee (FOMC) announced that it left the Fed Funds Target Rate (0-0.25%) unchanged, which was expected.

- In the statement itself, the Fed indicated that a formal tapering announcement was forthcoming on its $120bn in monthly securities purchases stating: "*If progress continues broadly as expected, the Committee judges that **a moderation in the pace of asset purchases may soon be warranted**.*"

- The "dot plot", or the 18 individual committee members' current expectation for future rate hikes (it is not a "committee forecast"), was adjusted higher and now implies one rate hike by the end of 2022 (median 0.3%) and three additional rate hikes in 2023 (median 1.00%) (**Figures 1 & 2**). 2024, a new addition to the "dot plot" this meeting, also shows three additional rate hikes, bringing the Fed funds rate to 1.75%. This implies that once the Fed does start raising rates, it will be 0.25% raise each quarter.

- From the June meeting, the Fed adjusted 2021 projected Core PCE inflation up from 3.0% to 3.7%, while 2022 was adjusted up from 2.1% to 2.3%. 2023 was also upgraded from 2.1% to 2.2%. Of note, a record number of committee members saw inflation risk to the upside.

Our takeaway:
With the market largely focused this week on the fate of China's large real estate developer Evergrande (Long-Dormant Fear Revives: China Property Risks Small Relative to Global Capacity to Absorb) along with any associated global economic impact, the FOMC meeting this week was a relatively low volatility event by comparison. On balance, the market did not expect much change in terms of Fed messaging on inflation or its "dot plots", other than to shift inflation forecasts slightly higher for longer, and to move its rate forecast slightly higher (via the "dot plot" scattergram).

That is what the Fed did, as even if the headlines note that the shift is "hawkish", the market reaction was extremely muted. Based on the change to the Fed's "dot plot" forecast, the market-implied policy rate shifted only slightly higher. Treasury bond prices, which have been trading in a tight range this past month, barely moved, with the 5y Treasury rate flat at 0.84%, while the 10y Treasury rate was also flat at 1.31%.

Today's Fed rate projections are again moving in the direction of acknowledging recovery, though delayed due to uncertainty around the future trajectory of COVID-19. In his press conference, Chairman Powell repeatedly noted that inflation remained transitory, while also continuing to state that the US labor market would see rapid gains as "*demand for labor is very strong*" and that for unemployment, "many" on the FOMC think that "substantial further progress" test for jobs has been met, and in his opinion "*all but met*".

These general points have been made repeatedly by Powell and others throughout 2021. But the big shift was in language around the "substantial further progress test" for taper, with the FOMC clearly signaling that it is imminent, as Powell noted that "*so long as the recovery remains on track, a gradual tapering process that concludes around the middle of next year is likely to be appropriate*".

Figure 1: 2022 FOMC Participant Short Rate Expectations - June Meeting vs September meeting

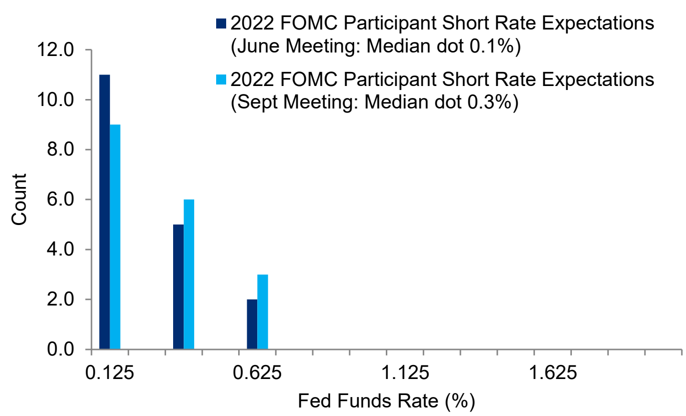
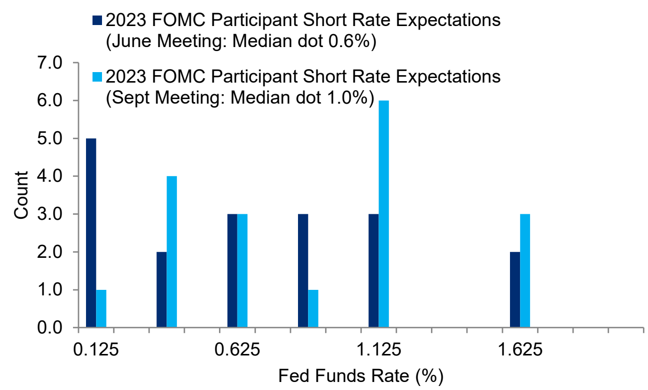


Figure 2: 2023 FOMC Participant Short Rate Expectations - June Meeting vs September meeting



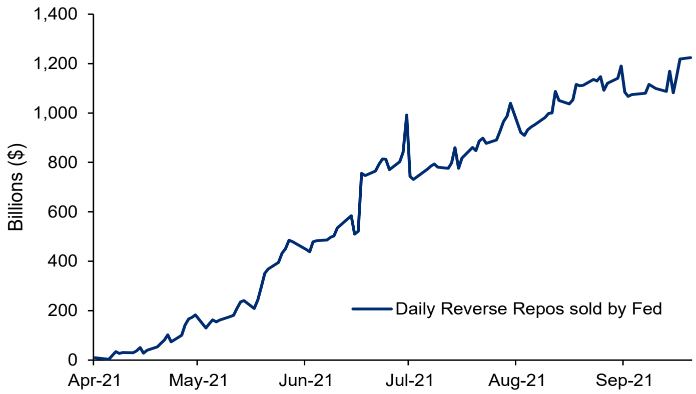
Source: Haver Analytics, FactSet as of September 22, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

In our view, the Fed is recognizing that many of the growth concerns affecting the bond market in recent months – the Delta variant, China's economic slowdown, and the fate of the Democrats' fiscal package – may soon be behind us. The Fed wants to now anticipate this "turn" back to a more full-throttled re-opening and get ahead of the curve, given persistently elevated (even if no longer rising) inflation readings. On this point, Powell noted that "*we appear to have achieved more than substantial further progress on inflation*."

It is likely that the Fed also recognizes that continued monetary accommodation is perhaps no longer providing support to the real economy (other than by keeping longer-term Treasury rates lower), as Powell stated that asset purchases "*usefulness is much less now*." Due to minimal aggregate loan growth by companies and consumers, quantitative easing provided by the Fed is largely cycling back to the Fed in terms of excess bank reserve balances (over $2.5 trillion added since the pandemic) and money market fund deposits in their Reverse Repo Program **(Figure 3)**. While there may be benefits in terms of improving asset valuations and overall market sentiment, the underlying message of the FOMC meeting this week was that the Fed is aware that it needs to taper but would like to see one or two more months of improving employment figures before it does so. Although Powell didn't say this, the Fed may also be waiting for the fiscal and debt ceiling debates currently in Congress to be resolved as well.

All of these factors continue to point to a November taper announcement, with $10-15bn of taper to begin shortly thereafter and to conclude by summer/early fall 2022.

Figure 3: US reverse repos sold by the Fed, daily



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Recent U.S. Treasury market comments:

Since early August, 10y Treasuries have held steady in a relatively tight range between 1.25% and 1.35%, as the market has been waiting for both more data on inflation/growth as well as the taper schedule. Now that the Fed has firmly signaled its intentions to taper soon, we would expect Treasury yields to drift higher absent any new exogenous shocks. This low yield range – despite high inflation prints - has led to a continuation of a steep negative "real yield" both in terms of market-priced real yields (the TIPS yield) at -1.00% and actual inflation-adjusted yield at -3.50% (realized annual headline CPI less the 10y yield, **Figure 4)**.

If this negative real yield does not correct higher over time, among other distortions it could lead to imbalances through commodity price or other asset price speculation (e.g. real estate). Since longer-term market-derived inflation breakevens for goods and services are often difficult to forecast, the market often uses commodity prices – for example copper- as proxies for the direction of inflation pressures, and while this is by no means a perfect relationship, it can often act as a good indicator market pricing of inflation **(Figure 5).** To the extent both real-end users and financial buyers of commodities perceive that the economy is re-engaging with growth and especially with re-opening, ultra-low bond yields may encourage additional buying of commodities, which in turn may impact inflation pricing. Due to this, we think that the Fed will be comfortable with somewhat higher rates as it seeks a delicate balance between both maintaining inflation expectations anchored above 2% for the foreseeable future per its stated goal, while also ensuring that those expectations don't become unmoored due to speculation.

The taper announcement, once they make it, should accomplish this goal by introducing uncertainty into the market over the ultimate range for rates and how that new range will in turn interact with the economy, thereby shifting 10y rates into a higher 1.50-2% range.

Figure 4: US TIPS yield vs nominal yield less CPI

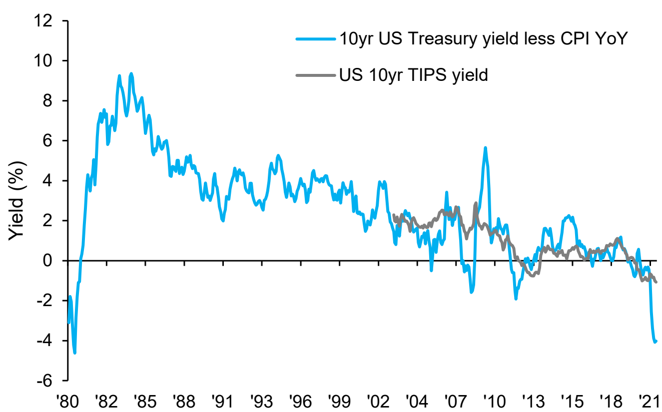
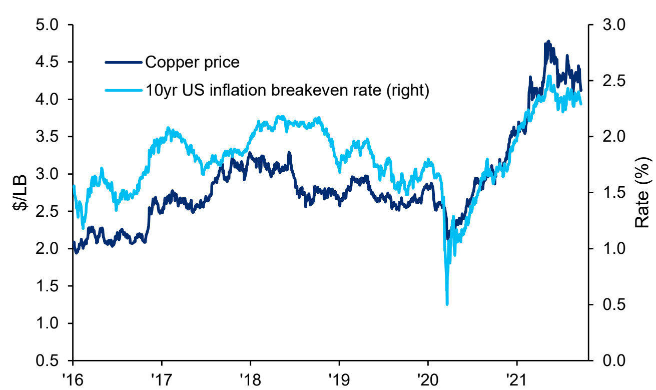


Figure 5: Copper price vs US inflation breakevens



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