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Global Fixed Income Strategy Bulletin

Fed (finally) announces taper: initial market reaction muted

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Summary

- At the conclusion of their FOMC meetings today, the Federal Reserve finally announced that it would begin its long-awaited (“tapering”) the $120bn of monetary accommodation it provides each month starting this month, by $10bn per month in Treasuries and $5bn per month in mortgage-backed securities
- At this pace, the Fed is likely to conclude the taper in June/July of 2022, though the Fed could adjust taper speed faster or slower depending on how the economy responds
- The Fed maintained its view on inflation, stating: “*Inflation is elevated, largely related to factors that are expected to be transitory*”, and added a line that – consistent with our view throughout 2021- clarified this point, saying “*Supply and demand imbalances related to the pandemic and the reopening of the economy have contributed to sizable price increases in some sectors*”
- The Fed Funds rate was left unchanged at 0.00-0.25%
- In his press conference, Chairman Powell reiterated the Statement’s comments on inflation, stating that “*the timing of a supply chain recovery is highly uncertain*” and that Fed tools alone “*cannot ease supply constraints*”.

Market reaction

- Initial Treasury market reaction was muted, with the 2y Treasury rate dropping slightly by 1pb to 46bps, the 5y flat at 1.19%, and the 10y and 30y steepening slightly by 3-4bps to 1.59% and 1.99%.
- Immediately following the Statement release and ahead of Powell’s press conference, US equities rallied modestly after the central bank suggested that it views near-term supply chain pressures as temporary. During the Chair’s press conference, risk assets rallied more significantly, led by higher-beta segments like small caps and technology. Given minimal reaction in bond and currency markets, with near-term hawkish risk now out of the way, the post-FOMC equity move is largely a continuation of a strong month for performance amid a solid 3Q earnings season.
- The dollar had little reaction to the Fed’s well anticipated tapering announcement. Markets have priced in 2-3 hikes by end of 2022 and 4-5 hikes by end of 2023 and it is indeed nearly impossible for the Fed to beat such hawkish expectations. Unless the Fed shifts to an even more hawkish stance which is quite unlikely given its view on the largely transitory nature of inflation, the already aggressive pricing of tightening means the dollar will likely stay range bound in the near term.

Comment on the announcement

In his press conference, Powell noted that the effectively tight labor market now doesn't fully reflect the possibility that those who have left the labor force as a result of COVID could return. He also made the point that the present inflation rise is not itself closely linked to the labor market, but rather COVID distortions (**see Figures 1-2**). We would include the one-off fiscal easing steps of 2020 and 2021 within these distortions. These comments helped risk assets by clarifying that the Fed does not see inflation as an intractable problem. The FOMC statement noted that easing supply constraints are expected to slow inflation.

Figure 1. Employment Cost Index and CPI for Core Services, YoY%

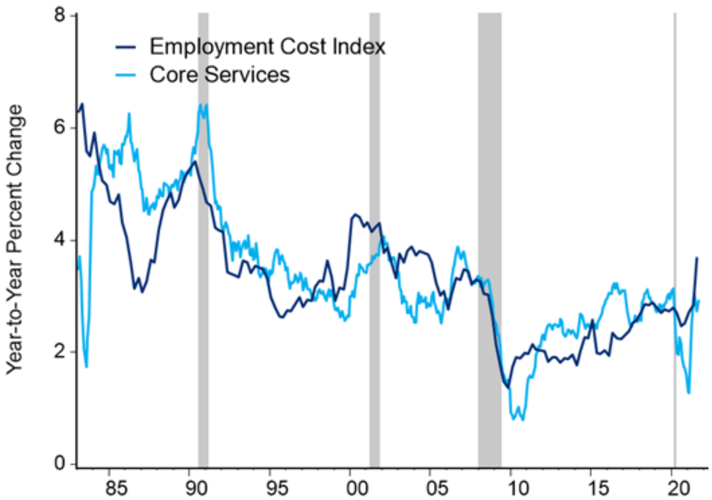
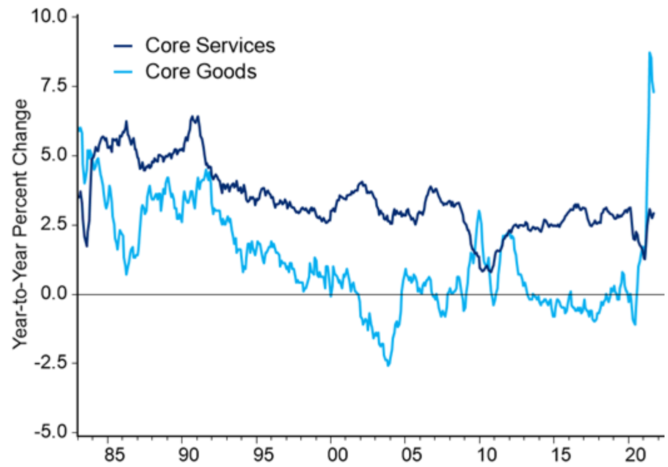


Figure 2. US Core Services vs Goods, YoY%



Source: FactSet, Bloomberg as of November 3, 2021. Note: Gray shaded areas are US recessions. 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.

The Treasury yield curve is now "higher and flatter" than it was a few months ago, with the short-end of the curve seemingly focused on inflation and the longer-end of the curve focused on slower growth. Since the last FOMC meeting ended on September 22nd, all yields on the curve have moved higher, and the curve has steepened at the short-end and flattened at the long end. **(Figure 3)**. We think that most of the move higher in yields may have already occurred in the early part of October, as the front-end of the curve priced in additional rate hikes due to more persistent inflation concerns. The Eurodollar market is currently pricing in almost three rate hikes for 2022, with three more in 2023 **(Figure 4)**. Inflation breakevens remain elevated **(Figure 5)**.

US Treasury yields may in part be also reacting to expected actions of other central banks. In countries such as the UK, Canada, Australia, Brazil, Poland and numerous others, central banks have or will soon be raising their own policy rates aggressively and halting their bond purchases in order to combat inflation. These expectations of policy actions are already having the effect of "higher and flatter yield curves" in these countries. Even in the Eurozone, where ECB policymakers are consistently maintaining both their negative policy rate and emergency bond buying programs, the curve has moved "higher and flatter".

We continue to see the Fed on track to normalize monetary policy in the next couple of years without a lurch to tighten policy abruptly.

Figure 3. US Treasury yield curve

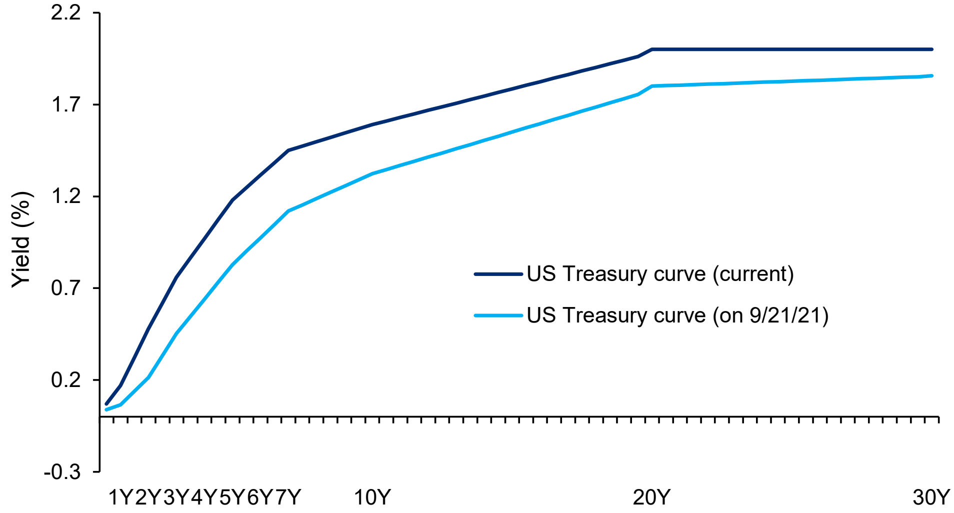


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Figure 4. Implied Fed Funds rates using Eurodollars

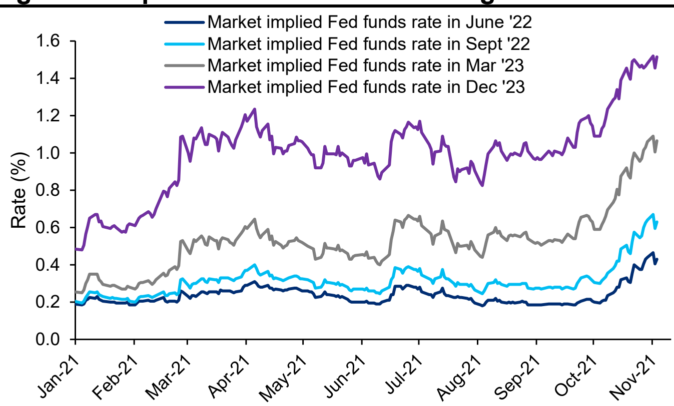
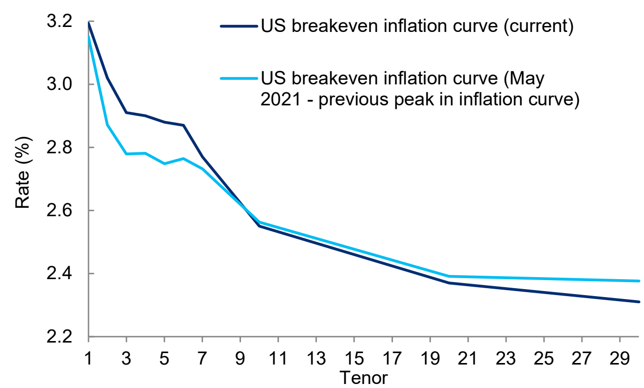


Figure 5. US Breakeven Inflation Rate Curve



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