Central Banks

Powell Rebuts Market Optimism with Dovish Defense

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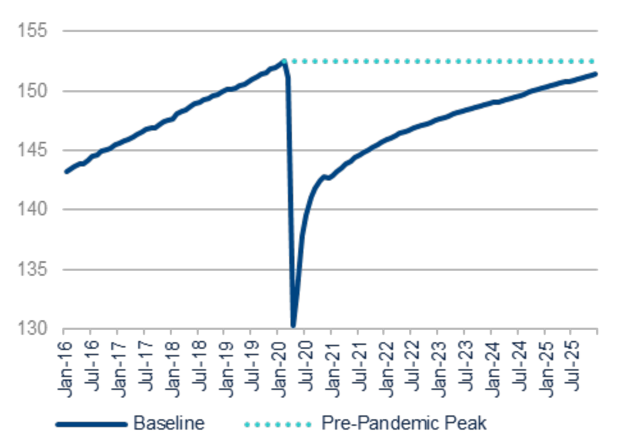
Today's communication from the Fed reaffirms our view that providing adequate accommodation is the committee's near-term and main focus. Getting out in front of hypothetical risks that monetary or fiscal policy present to financial stability or the near-term inflation outlook is not a top priority. As a result, interest rates and the commitment to purchase at least $80Bn of U.S. Treasuries and $40Bn of Mortgage-Backed Securities (MBS) per month were unchanged. Unlike the tone in recent communications that had trended positively, today's dovish statement reflected the slowdown in economic activity, signaling that conditions had "moderated in recent months, with weakness concentrated in the sectors most adversely affected by the pandemic." Furthermore, the FOMC statement included a reference to the importance of the vaccine rollouts, reflecting the increased ties between vaccinations' success and economic outcomes. At the meeting, the committee also reaffirmed its "Longer-Run Goals and Monetary Policy Strategy," cementing the standards of "maximum employment" and achieving "inflation moderately above 2 percent for some time."

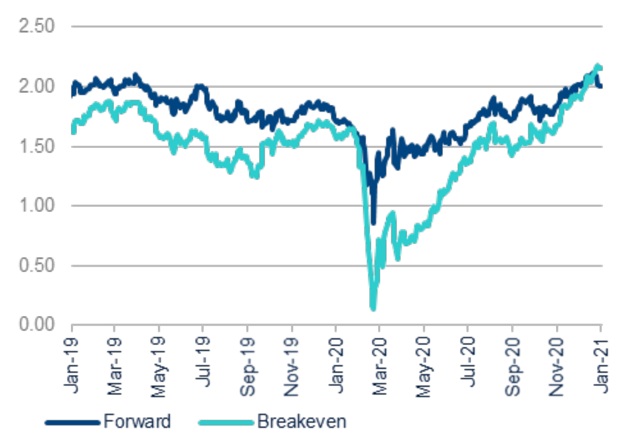
The third-quarter rebound was unprecedented, but economic activity remains far from what the committee needs to see to begin asset purchases tapering or any other step to remove accommodation. In fact, at the press conference, when asked whether Chair Powell was concerned that easy monetary policy was fueling asset bubbles, he commented that avoiding long-term economic scarring was a vital focus of the FOMC and that by some estimates, the economy was nine million jobs short of "maximum employment," which could even be an underestimate. Moreover, on the risks of transient versus sustained inflationary pressures, his sanguine comments and reference to short-term base effects, and risks to reopening, signaled, on the one hand, that the committee is not expecting a surge in inflation and, on the other hand, that it remains confident in its tools available to combat inflation.

Figure 1. **NONFARM PAYROLLS** (MILLIONS)



Source: BBVA Research & BLS

Figure 2. **5-YEAR INFLATION EXPECTATIONS** (%)



Source: BBVA Research and Fed

In a subsequent question on avoiding Fed-induced market volatility, Chair Powell said that taper talk is “premature” and that getting people back to work is “essential.” This reinforced the quelling signals from the Fed leadership after several regional Fed presidents indicated that the FOMC could start debating a tapering strategy by year-end if economic activity remained strong.

In addition, according to Powell, the potential for monetary policy to adjust to financial stability concerns was not theoretically inconsistent with the committee’s objectives, but the tradeoffs were not well established and thus would not explicitly factor into monetary policy decision making soon. As such, monetary policy accommodation will remain in place even if financial stability concerns rise, with the Fed opting for macroprudential intervention instead.

On fiscal policy, it appeared that the sense of urgency in the Fed’s call for more stimulus declined relative to past meetings. Specifically, the Chairman said that with the 2020 year-end Covid-19 spending package, fiscal policy has been in his view “strong and sustained.” His tone seemed to suggest that existing policy would be sufficient to avoid any significant deterioration in the economic outlook or promote long-term scarring. That being said, he noted in a line of questioning that he expected to have a strong “institutional” relationship with Treasury Secretary Yellen.

Today’s statement confirms our outlook that a successful vaccination strategy is paramount to support the economic recovery, that interest rates will remain low for a prolonged period and that tapering remains off the table at least until 2022. In addition, it also aligns with our view that although expansionary fiscal policy will help economic activity and the labor market to see a stronger recovery than previously expected, it does not represent a material risk to inflation.

After today’s meeting and the modest recoil in inflation expectations and near-term optimism, the 10-year Treasury yield edged down to 1% after reaching almost 1.15% two weeks ago. Our baseline remains for modest increases in long-term yields and a steeper yield curve slope throughout 2021.