Central Banks

Fed upgrades its outlook but tapering and liftoff are not in the radar

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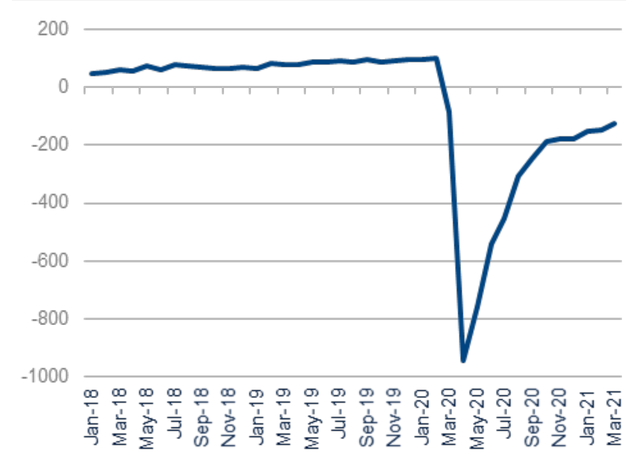
As expected, after the April meeting, the FOMC left interest rates unchanged and maintained the monthly pace of asset purchases of at least $80Bn and $40Bn in Treasury and mortgage-backed securities (MBS), respectively. Furthermore, the Fed kept its forward guidance unaltered.

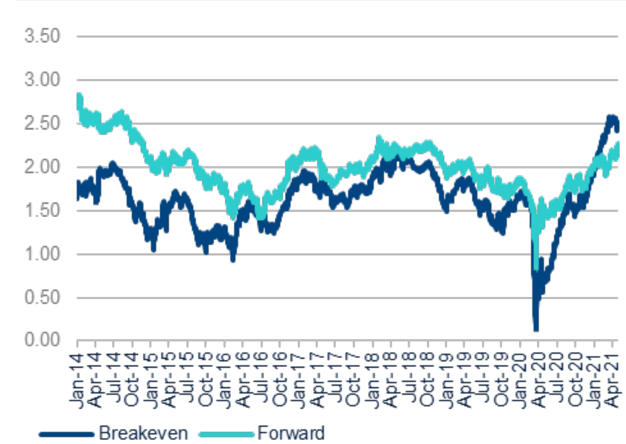
On the one hand, the statement provided a more upbeat perspective on both current conditions and expectations. In fact, the Fed acknowledged that economic and employment indicators have “strengthened” while sectors more heavily impacted by the pandemic “have shown improvement”. In addition, although the Fed reiterated that the economic outlook is dependent on the path of the virus and vaccinations, the assessment of potential risks was upgraded from “considerable” to “remain”. Likewise, while the statement recognized that inflation has risen, the Fed stressed that this was largely due to “transitory factors”.

Figure 1. **BBVA USA MAXIMUM EMPLOYMENT INDEX** (FEB 2020=100)



Source: BBVA Research and BLS

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



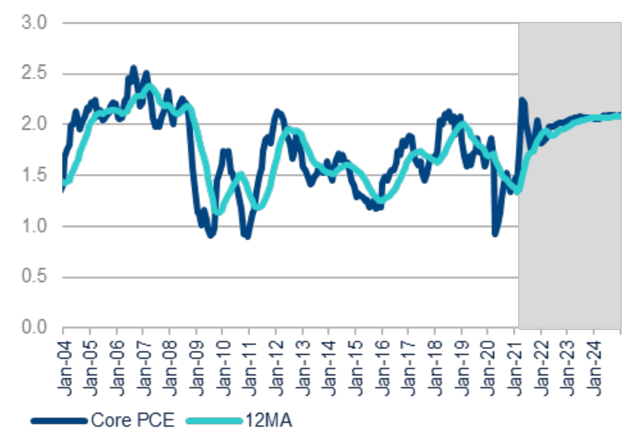
Source: BBVA Research and Bloomberg

However, on the other hand, Chair Powell stressed that the economy remains far the Fed’s goals of maximum employment and price-stability, and “it is likely to take some time for substantial further progress to be achieved”. In fact, payroll employment is still 8.4 million lower than pre-pandemic levels and “high level of joblessness has been especially severe for lower-wage workers in the service sector and for African Americans and Hispanics”. In addition, Powell indicated that 12-month PCE inflation will move above 2% as a result of base effects from the start of the pandemic, the rebound in energy prices, and demand pressures as the reopening of the economy continues. However, Powell stressed that these one-time price increases will only have transitory effects on inflation.

During the Q&A, Powell stressed the importance of controlling the virus to achieve a full recovery, particularly for activities involving large crowds and for “people who are around the edges of the labor force who won't come back in unless they feel really comfortable going back to their old jobs.”

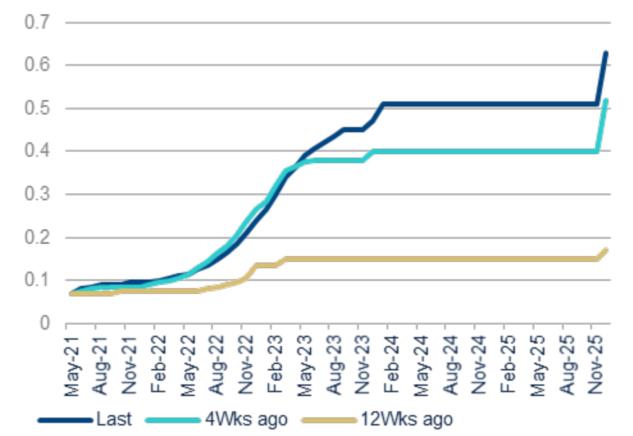
Asked about the potential risks of seeing a spike in inflation before achieving maximum employment, Powell indicated that this scenario is unlikely. However, if this were to happen, the Fed will weigh both factors to make a decision. Powell also stated that the Fed would be patient and not overreact to transient pressures on inflation. On fiscal policy, Powell indicated that such support has been essential for the recovery, but he avoided the discussion on whether more stimulus was needed or not. Finally, on the potential risk that accommodative monetary policy may be fueling asset price bubbles, Powell defended the Fed’s response to the crisis to avoid a deeper and more prolonged damage to the economy, and the need to maintain a high level of accommodation to support the recovery. Moreover, Powell stressed that “what has really been driving asset prices in the last couple of months is not monetary policy, it has been expectations about vaccines and it is also fiscal policy”.

Figure 3. **CORE PCE INFLATION (12-MONTH % CHANGE)**



Source: BBVA Research and BEA

Figure 4. **FED FUNDS FUTURES (%)**



Source: BBVA Research and Bloomberg

The combination of improved economic conditions, temporary price pressures and a substantial gap with the Fed’s goals has two main implications. First, while the Fed remains committed to communicate to the public when it is time to have a conversation on tapering, it will take some time before the Fed starts thinking about thinking about tapering. In an optimistic scenario of strong consecutive job gains, the earliest date would be the June meeting. However, under a solid but more volatile labor market improvement, the discussions would begin in September. Considering that communication will happen well in advance of the start of the process, tapering is more likely to begin at the start of 2022.

Second, the Fed wants to reassure markets that the new policy framework is based on realized outcomes. In other words, the inflection point in current conditions and the economic outlook in 2021 does not mean that monetary policy is on the same trajectory. The Fed needs to see a clear realization that inflation has moved above 2% for some time, that inflation expectations remain well anchored at 2%, and that maximum employment has been achieved before the Fed begins to raise interest rates.

On the inflation front, expectations are just shy of the threshold and thus what remains is for these to stay anchored. This is viable and should not pose a major risk to the Fed. However, while core PCE will move above 2% in the next few months, it will tick down once the base effects from the pandemic fade away and supply adjusts to meet the boost in demand. If monthly core PCE inflation averages slightly higher rates than before the pandemic, the 12-month core PCE will not stabilize above 2% until 2023. In other words, even if employment recovers at a solid pace and inflation expectations stay within the expected range, it is hard to envision the Fed raising rates in 2022 without a sharper realignment of inflation.

Bottom line

Today's statement confirms our view that a successful vaccination campaign remains critical to support the economic recovery, that higher inflation readings will prove temporary, and that a full recovery of the labor market could take several more quarters. As a result, our baseline remains unchanged with tapering unlikely to happen before 2022 and liftoff to occur in 2023. This implies that long-term yields will continue edging up albeit gradually, resulting in a steeper yield curve.