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BREAKING NEWS
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Fed set for a November taper despite weaker growth outlook

The Federal Reserve appears set to announce at its next meeting in November that it will begin to taper its $120 billion asset purchase plan, even as inflation data have softened and the Delta variant has interrupted parts of the economic recovery. Half of the members now expect the first rate hike of the cycle to happen next year. We're not so sure that will happen.

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WHAT HAPPENED?

The Federal Reserve Open Market Committee (FOMC) met to discuss how to steer monetary policy in an environment of slowing growth and inflation. The headline from this meeting is that the Fed intends to announce plans to trim its asset purchases – known as quantitative easing – at its next meeting on November 3.

The FOMC's statement noted that, given the drop in unemployment, "a moderation in the pace of asset purchases may soon be warranted." That's Fedspeak for "expect us to announce a taper at the next meeting." This was widely expected and generated little market reaction. Fed Chair Jay Powell went further in his press conference to note that the committee expects its asset purchase program to fully wind down around the middle of next year.

This meeting also offered FOMC members a chance to update their individual forecasts for the economy and the appropriate path of interest rate policy, known colloquially as the "dot plot." As expected, the median forecast moved higher for inflation but lower for growth. The Fed sees the recent rise in COVID-19 cases as delaying progress on the recovery into 2022, which led it to downgrade its GDP growth forecast for 2021 (5.9% from 7.0% in June) but upgrade it for 2022 (3.8% from 3.3%).

Notably, the median forecast for core PCE price inflation for 2022 rose to 2.3% from 2.1% in June. That corresponded with more members who now believe increases in the federal funds rate target will be appropriate next year. Half of the committee now believes at least one hike will be warranted next year, up from 7 out of 18 in June. The median forecast for the fed funds target rate at the end of 2023 is now 1%, reflecting three to four cumulative rate hikes. The Fed also initiated a forecast for 2024, with a median expectation that the target rate will finish that year at 1.75%.

Chair Powell took the opportunity in his press conference, as he so often does, to caution against reading too much into the dots or the forecasts. But the committee is clearly divided on whether and when to tighten monetary policy. The Fed's leadership – Powell plus the Board of Governors – would likely prefer to remain more patient. However, many of the Fed presidents – only a minority of whom can vote on policy changes in any given year – are by and large more hawkish.

NO PRESSURE ON THE FED TO TIGHTEN

Since the Fed last met in July, most economic data have come in softer than expected, most notably the August employment report. Last week, we learned that U.S. consumer price inflation also decelerated over the summer, as the rapid rise in durable goods prices earlier in the year has paused and begun to reverse in some sectors. The Fed's median inflation forecast for 2021 has increased since June, but the committee is now more interested in whether the softer August data will persist and where inflation ultimately lands next year.

It's also still not clear how large an impact the Delta variant is having on the U.S. economy. August retail sales data, for instance, showed U.S. consumers continuing to spend at a surprising clip, even as more of them preferred to shop online. Until that report was released, consensus estimates for third quarter GDP growth had been falling on the assumption that consumers were pulling back. Some decline in spending is inevitable as the effects of fiscal stimulus wear off. But even as the tax credits and other government transfer payments are wound down, the accumulated savings they helped to create have led to a durable increase in consumption.

Meanwhile, the wealth effect of rising housing and financial asset prices should support consumer confidence – in deed if not in word – for the foreseeable future. Even so, it seems clear that the second quarter will mark the peak for GDP growth in this cycle.

As both inflation and growth decelerate from multi-decade highs in 2021 to merely above-average rates in 2022, it's not clear the Fed will (or should) feel much pressure to tighten policy through interest rate hikes. The bond market, for one, is certainly not calling for action. While the Treasury yield curve has been steepening gently since July, the gap between the 2- and 10-year yields – often used as a barometer for expectations about monetary policy shifts – is still well below its March peak. Money market futures have been shy about pricing in even one interest rate increase next year. We do not expect a rate hike until 2023, but we acknowledge the risks are tilted toward an earlier liftoff if inflation remains well above the Fed's 2% target even after the effects of this past spring's surge fade.

A NEW CHAIR? WE DOUBT IT

The cloud hanging over this meeting is President Biden's imminent decision on whether to reappoint Powell for a second term as Fed Chair. Powell was originally nominated to the board by President Obama in 2012 and was elevated to his current status by President Trump in 2018. He has won accolades from economists and politicians for his actions to forestall a financial crisis during the early days of the COVID-19 pandemic. Even more important for his chances to retain the job, he has ushered in fairly radical changes to the Fed's inflation-targeting policy. The upshot of this reform has been an increased tolerance of higher inflation in service of looser financial conditions and faster wage growth, especially for workers at the lower end of the income scale.

Senators who oppose Powell from the left argue that he has not been forceful enough in enforcing the Fed's other key function, financial regulation. This objection may lead Biden to nominate progressive candidates for the multiple openings on the Board of Governors even as he retains Powell to lead the bank.

The timing of all of these appointments remains uncertain, as fiscal policy challenges have taken center stage in Washington, D.C., this fall and are likely to tie up Congress through late October. We expect Powell and at least two other new board members to be named and seated by February 2022.

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Endnotes

Sources

Federal Reserve Statement, September 2021.

Bloomberg, L.P.

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