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BREAKING NEWS
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Fed taper begins, but rate hike timing remains uncertain

The Fed is winding down its quantitative easing program, as emergency monetary policy is no longer warranted. Now policymakers will have to consider whether and when to raise interest rates. We believe the Fed will remain more patient than the market expects.

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WHAT HAPPENED?

The Federal Reserve Open Market Committee (FOMC) has, as expected, announced the beginning of the end of its asset purchase program, commonly known as quantitative easing (QE). The Fed will reduce its purchases by $15 billion starting this month, and expects to continue doing so each month until the purchases run out in mid-2022.

QE was originally undertaken to add liquidity during the spring 2020 market crisis caused by the onset of the COVID-19 pandemic. After that crisis was largely resolved, QE's raison d'être morphed into ensuring financial conditions remained accommodative to foster a strong economic recovery. Now that the recovery seems well in hand, the risks of continuing to add large amounts of liquidity to the system roughly offset the ongoing benefits.

The Fed continues to regard the current period of elevated inflation as transitory. However, those who make a hobby of parsing Fed statements will note that the committee changed its language subtly this month. It now says that inflation is being driven by factors that are "expected to be transitory," while the prior statement said inflation "largely reflect[ed] transitory factors." While that may seem like nothing, such changes are made for a reason. The Fed also added a sentence correctly ascribing the bulk of inflation to supply and demand imbalances related to the pandemic and reopening.

Chair Jerome Powell noted in his press conference that the Fed's tools "cannot ease supply constraints," but expressed optimism that those constraints would ease on their own and the labor market would continue to improve. The U.S. Treasury yield curve steepened after the statement's release, indicating that investors do not expect the Fed to err by raising rates too quickly.

STAGFLATION? NOT QUITE

U.S. economic growth slowed considerably in the third quarter, even as the year-over-year rate of inflation has remained high. Many have likened this period to the so-called stagflation of the 1970s. But we see important differences between this period and then, which preclude us from using that label to describe the current environment.

First, stagflation requires a certain set of fiscal and monetary policies and a healthy dose of bad luck,

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most of which are not present today. Back in the 1970s, when inflation began to run hot, the U.S. enacted price controls, which had the perverse effect of reducing hiring demand – putting the "stagnation" into "stagflation" – just as energy costs were rising further thanks to an OPEC oil boycott and unrest in the Middle East. The two necessary ingredients for stagflation are a) a negative supply shock of a commodity like oil; and b) an inability for companies to raise prices to offset that shock.

Today, we are certainly seeing supply shortages, particularly of manufactured goods and certain raw materials. But these have come about as a result of positive demand shocks: The global economy's reopening and the massive stimulus to consumers and businesses throughout the pandemic. Consumer demand, as well as businesses' demand for new workers, still appears to be quite strong. So while consumer price inflation is running at its highest level since the 1990s, the "stag" portion of stagflation remains absent. In fact, as supply chain issues are addressed, we expect real U.S. GDP growth to reaccelerate this quarter, while demand-drive inflation continues to moderate.

REDEFINING "TRANSITORY"

While the "stagnant" part of stagflation is thankfully missing, we cannot argue with those who point out that U.S. inflation has reached a far higher peak than projected. The second quarter, in particular, saw a rare combination of explosive demand met by an inadequate increase in supply, especially for durable goods like cars.

We have agreed with the Fed's assessment that the 2021 vintage of consumer price inflation is transitory, but as this word has become something of a punchline we feel a clarification is in order. We'll define "transitory" inflation moving forward as inflation that will fade on its own without requiring tighter monetary policy. This definition is agnostic to how long the transitory period lasts, and focuses instead on the heart of the matter: The Fed should not and will not raise interest rates to dampen it.

The Q2 burst of inflation still qualifies as transitory. In fact, its effect is already fading as consumers rotate away from expensive goods and toward services whose prices have still largely not returned to their pre-pandemic levels.

However, we also see evidence that a more permanent form inflation is taking root, driven by a shortage of workers, rising wages and increasing rents. Should these become the driving forces behind inflation's 2022 vintage, the Fed may be forced to respond with higher interest rates. Indeed, the markets have been busily pricing in this scenario in recent weeks. There is now a full rate hike priced into the fed funds futures market by July. That would mean the Fed would be tightening just as quantitative easing was coming to an end. After the last winding down of QE in 2014, the Fed waited a year to raise interest rates and then another year to raise them again. But this cycle is different: Demand has recovered far more strongly and unemployment may fall below 4% in the coming months, something it did not do in the prior cycle until almost nine years after the recession ended.

On the other hand, this version of the Federal Reserve has shown itself to be exceedingly tolerant of inflation as it attempts to foster strong and broad-based wage growth in the still-early days of this cycle. Two or three new Fed governors will be on their way in the next few months to fill vacancies, and they are likely to be even more tolerant of moderately high (i.e., 2.5% to 3%) inflation next year than those they are replacing.

The key determinant will be the labor market. We have seen the unemployment rate fall quickly, but labor force participation among prime-age workers continues to languish well below its January 2020 level. If more workers stream into the jobs market, it will take pressure off of the Fed to quickly raise rates to forestall a wage-price spiral. If they don't, the market's current expectations for a mid-2022 rate hike may end up looking prescient.

For more information, please visit us at nuveen.com.

Endnotes

Sources

Federal Reserve Statement, November 2021.

Bloomberg, L.P.

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