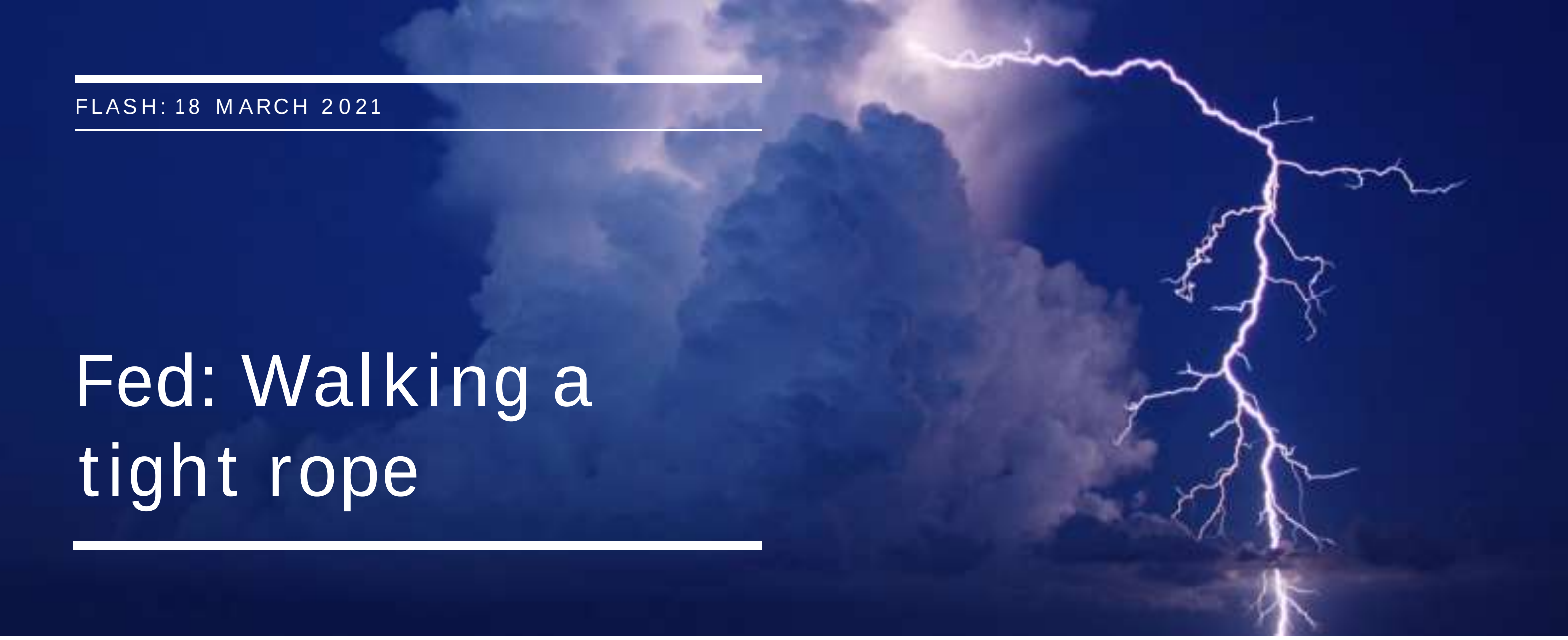

FLASH: 18 MARCH 2021

Fed: Walking a tight rope

Summary

- The Fed has maintained a dovish tone.
- Although it has revised its economic projections upward, it does not see any imminent reduction in asset purchases and does not plan to raise rates in the next two years.
- It projects a temporary rise in inflation in 2021, but not beyond.
- Powell believes that the Fed does not have to act at this point to stop/slow down the rise in long-term yields.
- Financial conditions, the labour market and inflation are the key indicators that will drive any change in monetary policy.
- We anticipate the announcement of the reduction in asset purchases in 4Q21 with implementation in 2Q22 and a first rate hike in 3Q23.

Improvement since December

Since 16 December, 2020, the date of the latest Federal Reserve (Fed) with economic projections, health conditions and economic activity have improved significantly. The number of daily Covid infections has dropped by 80% from January, a $900 billion rescue plan was passed in December, followed by another $1.9 trillion in March, and the economy has begun to gradually reopen. Economic growth projections have been revised upward. The consensus of economists now expects 5.5% growth in the US in 2021. Some major US banks are even forecasting 7%.

Bond markets adjusted: the yield on the 10-year Treasury note rose by 0.70% to 1.62% due to the improved inflation expectations and the rebound in real rates. The market has also strongly pulled forward the sequence of interest rate hikes. It sees a first rate hike as early as December 2022, followed by 2.5 hikes in 2023.

The Fed's goal for its March 16-17 monetary policy meeting was therefore to justify maintaining its very accommodative policy while acknowledging that the economy had improved significantly.

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The Fed's new economic projections

More growth temporarily. The Fed sharply revised its growth projections for 2021 to 6.5% from 4.2% (projections made in December 2020), but hardly any for the years beyond.

Less unemployment. The Fed expects the unemployment rate to fall faster in 2021 than previously expected (4.5% versus 5.0% in December 2020), with a drop to 3.5% in 2023. Note, however, that the unemployment rate is not really representative of the number of unemployed, as the participation rate remains below its pre-Covid level.

More inflation temporarily. The Fed estimates that inflation will be higher in 2021 (2.4% versus 1.8% in December 2020 for headline inflation and 2.2% versus 1.8% in December 2020 for core inflation). However, it then expects inflation to return to its 2% target in 2022 and 2023. Thus, even if pockets of inflation can be observed in certain sectors (health care, food, shelter), the Fed does not believe that this is a permanent increase. It will therefore tolerate this temporary excess, in line with its new policy of averaging 2% inflation over a certain period.

No big decisions

As widely expected, although economic projections have improved, the Fed kept its policy rates unchanged (0%-0.25%) and left in place its asset purchase programme of $120 billion per month ($80 billion in Treasuries and $40 billion in Mortgage-Backed Securities).

Dots: not to read too much into it

The dots (individual projections of each of the 18 members of the Fed) are always closely watched by the market, much to the chagrin of the Fed, which tirelessly points out that these are individual views based on individual macroeconomic projections and therefore not derived from a consensus. In any case, they give an indication of when the first rate hike will take place.

The median has not moved, so Fed members do not expect a rate hike in the next two years. That said, 7 members (up from 5 in December 2020) think rates will need to be raised at least once in 2023. This is certainly not a majority, and we can guess that it is the regional Fed presidents behind (less influential than the governors), but a consensus is gradually forming and promises more agitated meetings in 2022-2023.

Tapering? Later.

Tapering (reduction of asset purchases) is not for now, according to the Fed Chairman. First, substantial progress must be made. The Fed promises to inform the market well in advance.

We anticipate an announcement at the end of this year due to the expected strength of the economic recovery, with a gradual reduction in asset purchases starting in the second quarter of 2022.

Raising policy rates? Even later.

Powell was clear. No rate hikes are to be expected until "further substantial progress" has been made on the inflation and unemployment fronts. Inflation needs to be moderately above 2% for some time (probably a year). It also requires a return to maximum employment, to which the Fed is adding a new social dimension, since in addition to aggregate data, it will look at the employment levels of certain categories of the population such as African-Americans, Latinos and women, who are generally the first to be affected by the crisis and the last to emerge.

We expect policy rates to rise for the first time in the third quarter of 2023.

What about the level of long-term rates?

Powell did not deviate from the messages repeated in his last speeches: the rise in long-term rates reflects the recovery in economic activity. Monetary policy is appropriate. In short, the Fed will not act because financial conditions remain accommodative and there has been no dysfunction or correction in financial markets.

SLR ratio? "Ask me another question."

This regulatory uncertainty has been blamed for the volatility in long-term rates. The Fed had implemented a relaxation in the calculation of the Supplementary Leverage Ratio (SLR) following the Covid crisis as it feared that leverage requirements could damage banks' ability to finance the economy and support the smoot functioning of financial markets. The Fed must decide whether or not to renew it by March 31. If it does not renew it, the big American banks could limit their purchases of Treasury bonds to meet this ratio, which would add upward pressure on long-term rates.

In the end, no strong market reaction

Powell's dovish tone was beneficial to risk assets. Equity markets returned to the green after the Fed meeting. The US 10-year yield fell, which benefited corporate bonds and emerging market bonds. The dollar depreciated.

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