4X Global Research

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Powell Put in play but greater challenges ahead

Federal Reserve Chairperson Jerome Powell's pre-prepared opening speech at the Jackson Hole Symposium on Friday afternoon was a key litmus test for the central bank.

Powell took yet another small step towards an eventual tapering this year of the Fed's asset purchases and a tightening of arguably extremely loose monetary policy while pouring cold water on any talk of policy rate hikes, broadly in line with our expectations.

Price action in US rates, equity and FX markets in the past four days would suggest that Powell has successfully cleared yet another important hurdle.

US Treasury yields across the maturity spectrum are down since Thursday's close in the bottom half of their post 16th June Fed policy meeting range, the US Dollar has weakened about 0.7% to a 3-week low and the S&P 500 is hovering near a record-high (see Figure 1).

National financial conditions remain very easy and supportive of domestic economic growth. Notably recent market moves have been orderly, with volatility still pretty modest.

The next hurdle for the Fed and financial markets is the 22nd September policy meeting, with the spike in market volatility following the 16th June meeting still fresh in their minds.

We think the Fed will refrain from giving a more specific timeline for the start of its taper and do so only at its 3rd November meeting to retain some data-dependent policy flexibility.

However, we expect the Fed's updated dot-chart to show a further hawkish shift in terms of the appropriate timing for policy rate hikes. Whether this jars, even if temporarily, with Powell's disassociation between QE and interest rate policy is open to debate.

We are for now sticking to our core scenario that the Fed will only start hiking its policy rate in 2023 but that the gap between the start of the taper and the start of the rate hiking cycle will be smaller than the 23 months gap in 2014-2015.

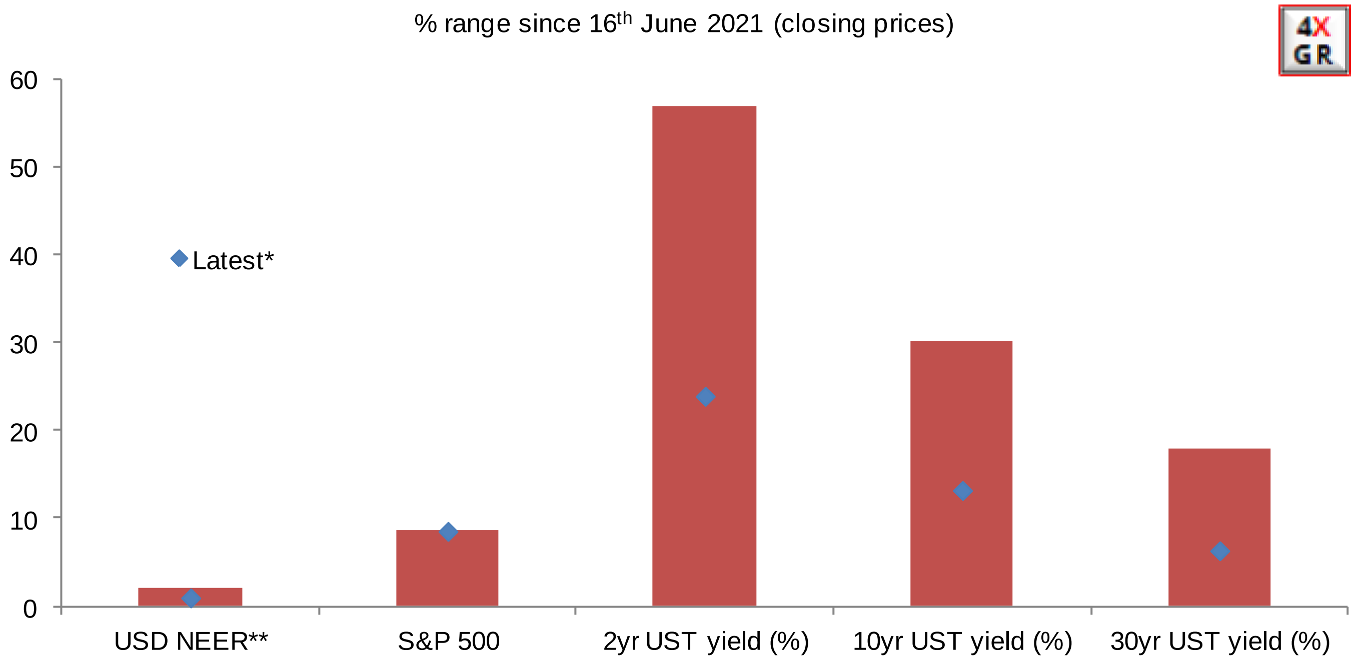
Nevertheless, the Fed will want to engineer a slow landing – music to the ears of doves and bulls but arguably a concern for hawks fearful of the Fed and financial markets stalling.

One small step for the Fed, one moderately dovish/bullish leap for financial markets

Federal Reserve Chairperson Jerome Powell's pre-prepared opening speech at the Jackson Hole Symposium on Friday afternoon was a key litmus test for the central bank. Powell took yet another small step towards an eventual tapering this year of the Fed's asset purchases and a tightening of arguably extremely loose monetary policy while pouring cold water on any talk of policy rate hikes.

Price action in US rates, equity and FX markets in the past four days would suggest that Powell has successfully cleared yet another important hurdle, even if he may face sterner tests in coming weeks and months. US Treasury yields across the maturity spectrum are down since Thursday's close in the bottom half of their post 16th June Fed policy meeting range, the US Dollar has weakened about 0.7% to a 3-week low and the S&P 500 is hovering near a record-high (see Figure 1). National financial conditions remain very easy and ultimately supportive of domestic economic growth. Importantly recent market developments have been "orderly", with asset price volatility still pretty modest by our estimates.

Figure 1: US financial conditions remain very easy and supportive of domestic economic growth



Source: 4X Global Research, Federal Reserve, investing.com

*Note: 31st August for S&P 500, 1st September (at time of writing) for Treasury yields and US Dollar; **USD NEER is US Dollar Nominal Effective Exchange Rate (calculated using Federal Reserve trade weights)*

Tapering on course to start this year but priority still given to US growth and labour market

Powell noted that the economy had now met the test of "*substantial further progress*" towards the Fed's inflation target while the labour market had also made "*clear progress*" towards maximum employment. He followed up by stating that "*At the FOMC's recent July meeting, I was of the view, as were most participants, that if the economy evolved broadly as anticipated, it could be appropriate to start reducing the pace of asset purchases this year*".

The implication, even if not explicit, is that the Fed could start tapering this year its monthly purchases of Treasuries and agency mortgage-backed securities, currently running at respectively $80bn and $40bn. However, he fell short of specifying a clear timetable for tapering, in line with our view that "*he could today flesh out the timeline for the Fed's announcement of when it will actually start to reduce its monthly asset purchases […]. However, we think it is unlikely that Powell will today tie the Fed to a hard-baked timeline"* (see Armchair Trader, 27th August 2021).

Our take is that Powell is keen to retain a degree of data-dependent policy flexibility. Indeed he referred no less five times to the Fed's focus, monitoring and assessment of "*incoming data*". More broadly, we would argue that in the battle between high inflation and potential headwinds to domestic economic growth (and in particular the US labour market) Powell is still siding with the latter. He had little choice in our view, in order to shore up the Fed's inflation-targeting credentials, but to note that US inflation was high and warn that forecasting inflation was a tricky exercise. However he also presented in great detail five distinct arguments as to why high and above-target US inflation was likely to be transitory – a by-now well versed argument. Moreover, he alluded to the Delta variant of the Covid-19 virus on three separate occasions.

Powell severs link between taper and rate hikes with spotlight on *maximum* employment

Importantly Powell made clear that reducing monthly Fed bond purchases should not be interpreted as a sign that policy rate hikes would soon follow, specifically that *"The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test […]. We have much ground to cover to reach maximum employment, and time will tell whether we have reached 2 percent inflation on a sustainable basis*".

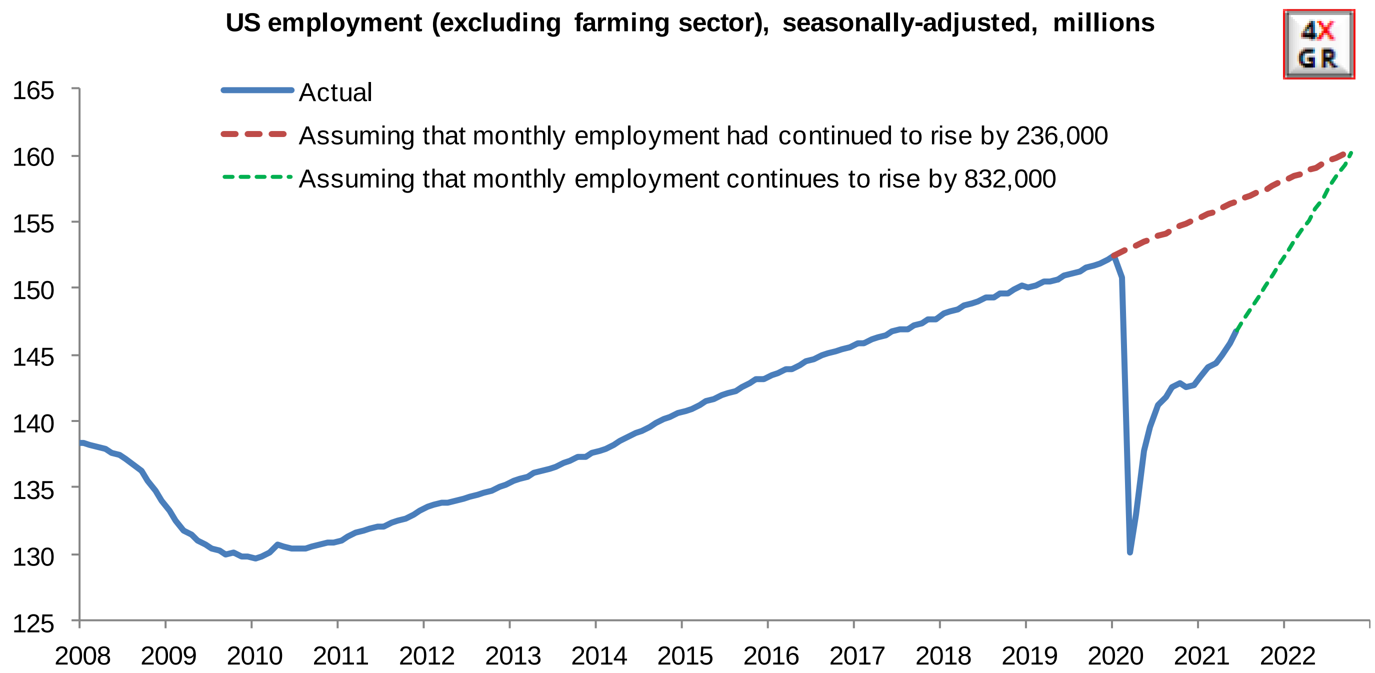
Our interpretation is that Powell wants the narrative and financial markets to clearly focus on tapering for now. His emphasis on the current gap between employment and *maximum* employment is particularly noteworthy. The US economy created a further 943,000 jobs in July (the highest monthly print since August 2020) and an average of 832,000 jobs per month in May-July (a point Powell made in his speech). The US economy has created an impressive 4.3 million jobs year-to-date.

However as we (and the media) have noted total employment (excluding farming) remains 5.7 million short of its pre-pandemic and all-time high level of 152.5 million in February 2020 (see Figure 2). Employment in the private-sector is still 4.9 million short of its pre-pandemic level. Moreover, this "static" analysis ignores the likelihood that without the pandemic US employment would have continued to rise, as it has done consistently since 2010.

Put differently, the Fed's figure for "*maximum*" employment could conceivably be materially higher than the 152.5 million recorded in February 2020. If we assume that monthly employment had continued to rise by about 236,000 post February 2020 (the average employment increase between September 2019 and February 2020) and that monthly employment going forward continues to rise by 832,000, we estimate that US employment will only return to "trend" in November 2022 (see Figure 2).

Of course this is an overly-simplistic approach conditioned by a number of basic assumptions but nevertheless gives some perspective about how far the US labour market could still actually be from the Fed's measure of maximum employment. After all the Fed knows better than to attach a hard number to a dynamic metric such as maximum employment. However, Powell made dents in the idea that all is well in the US labour market, stating that "*The unemployment rate has declined to 5.4%, a post-pandemic low, but is still much too high, and the reported rate understates the amount of labor market slack. Long-term unemployment remains elevated, and the recovery in labor force participation has lagged well behind the rest of the labor market, as it has in past recoveries*".

Figure 2: February 2020 employment peak may arguably not equate to *maximum* employment



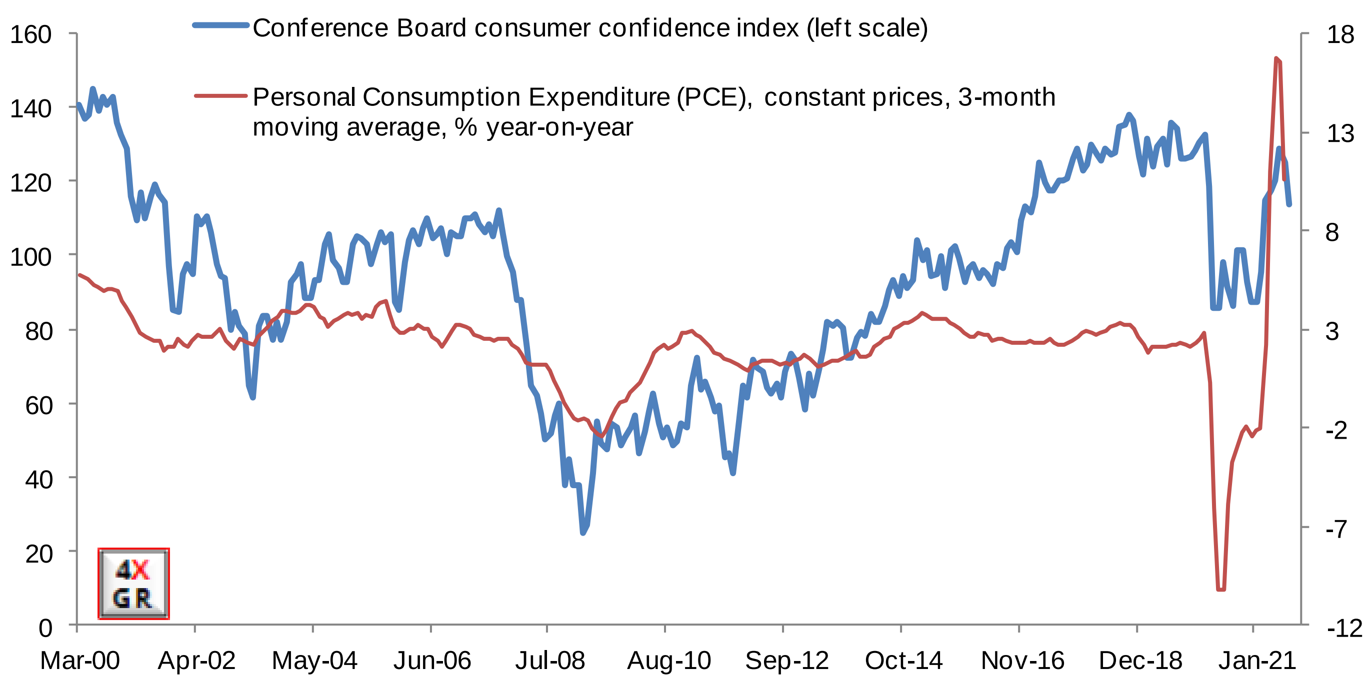
Source: 4X Global Research, US Bureau of Labour Statistics

As far as Powell is concerned it was job well done (for now)

We had argued in our Armchair Trader article that short-term Powell wanted to avoid a "misjudged" Jackson Hole speech which would "*set in motion events which destabilise financial markets*" and unnecessarily rock a "*reasonably stable boat*" and which could in turn depress US (and global) economic growth. The Fed and Powell would of course strongly refute allegations that it is pump-priming the US economy, via quantitative-easing and low policy rates, partly to fuel US equity markets. But neither are they oblivious to the transmission mechanism from financial markets to the real economy.

After all there is compelling evidence, in our view, of a strong, positive historical correlation between US disposable income (including wages & salaries), US consumer confidence, households' net-worth (including equity holdings), and PCE inflation (see The key quartet: US income, confidence, net worth and consumption, 18th September 2019). With this in mind we note that data out yesterday showed that US consumer confidence fell further in August to its lowest level since February. The Conference Board consumer confidence index fell far more than expected to 113.8 from a downwardly revised 125.1 in July. This was the largest monthly fall (-11.3 percentage points) in the index since the pandemic-related collapse in April 2020 (see Figure 3).

Figure 3: Fed will be aware that consumer confidence (and equities) help underpin private consumption

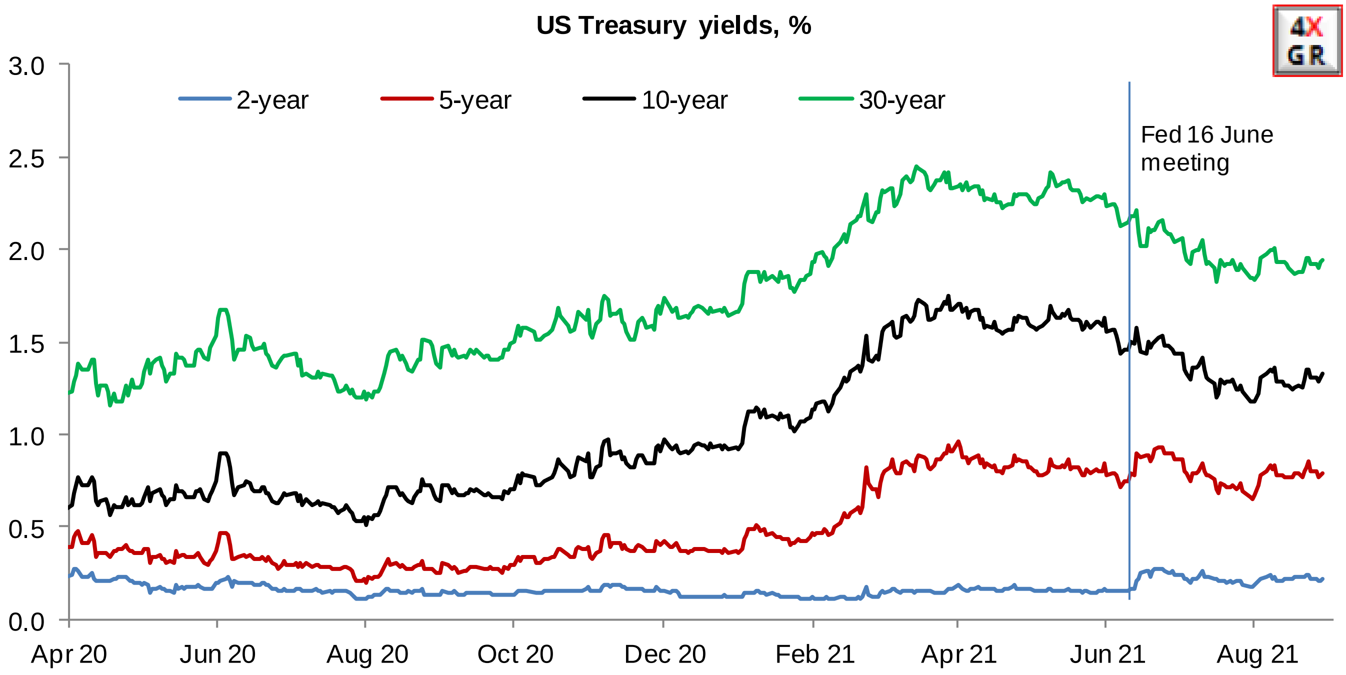


Source: 4X Global Research, US Bureau of Economic Analysis, Conference Board

Financial markets' reaction in the past few days – dovish for rates and bullish for FX and equities – suggest that Powell has largely succeeded, for now at least.

- The 2-year US Treasury yield fell about 2bp during Powell's speech and is currently down about 3bp from 26th August, in the lower half of its post 16th June Fed policy meeting range (see Figures 1 & 4).

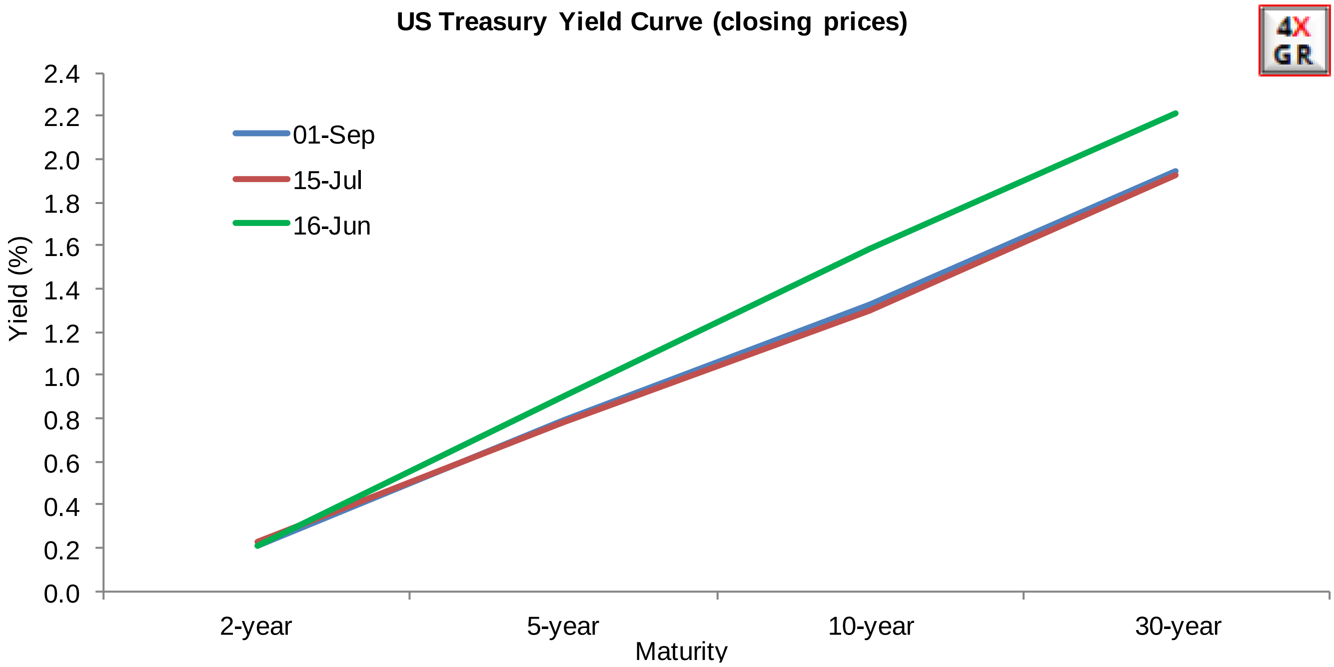
Figure 4: US Treasury yields stable since Jackson Hole speech, down since Fed's 16th June meeting



Source: 4X Global Research, investing.com

- The shape of the US Treasury yield curve is currently broadly the same as it was on 26th August and in mid-July (see Figure 5).

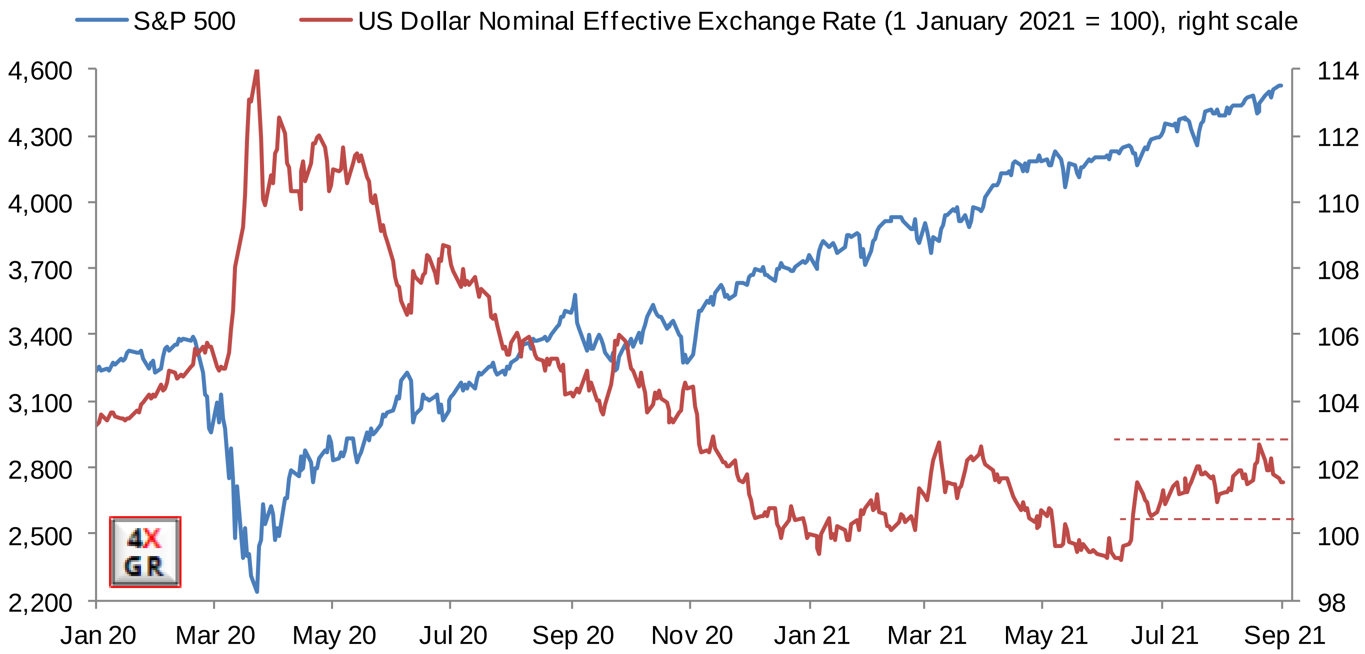
Figure 5: US Treasury yield curve broadly unchanged since Powell's speech (and since mid-July)



Source: 4X Global Research, investing.com

- The S&P 500 is up about 1.2% since the close on 26th August and only 0.1% from the all-time high recorded on Monday (see Figure 6).

Figure 6: US Dollar remains range-bound, S&P 500 within touching distancing of record-high

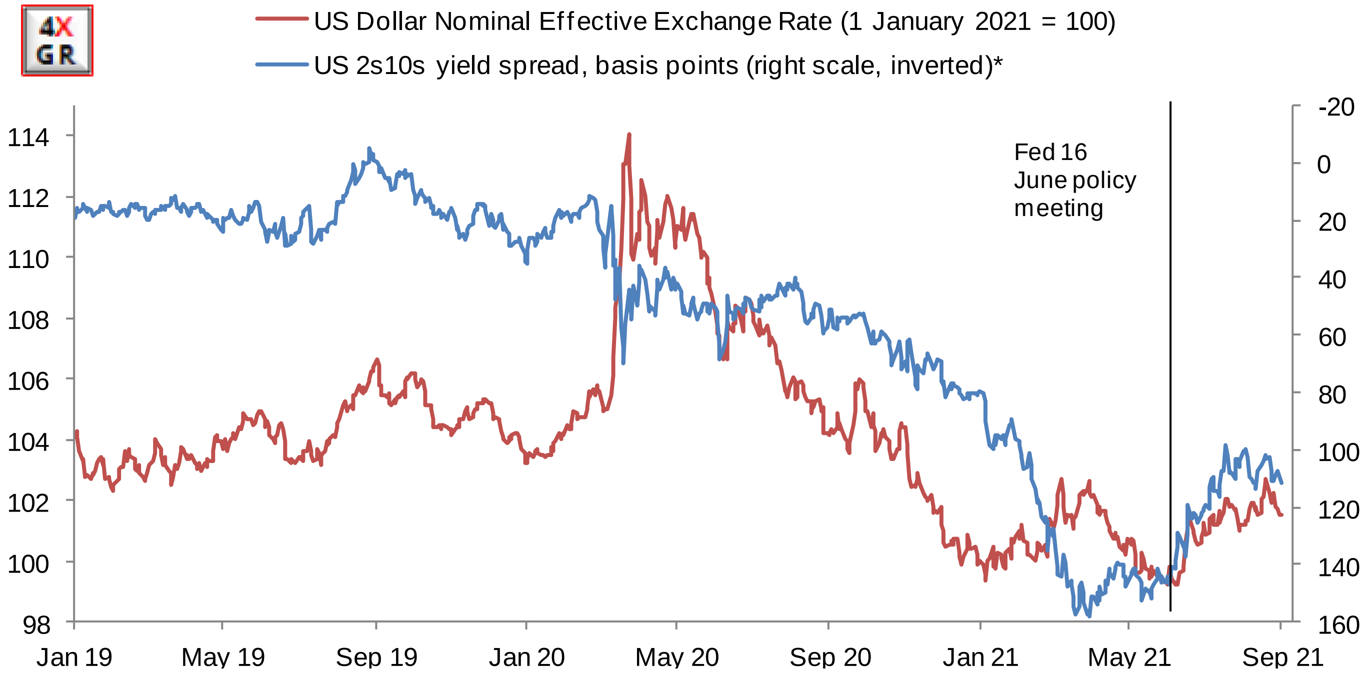


Source: 4X Global Research, Federal Reserve, investing.com

- The Dollar Nominal Effective Exchange Rate (NEER) has depreciated about 0.7% since 26th August to its weakest level in three weeks although it is still broadly in the middle of a narrow 11-week range of only 2.1% according to our estimates (see Figure 6). The Dollar's downturn has broadly mirrored the S&P 500's rally in the past four sessions.

  However, it has become a stretch to argue that the Dollar consistently trades like a "safe-haven" asset – during long periods this year the Dollar and S&P 500 have moved broadly in tandem. Notably since late-April the Dollar NEER has been inversely correlated to the steepness of the 2s-10s Treasury yield spread (see Figure 7).

Figure 7: Dollar still moving in tandem with 2s-10s Treasury yield spread – i.e. not much in past six weeks

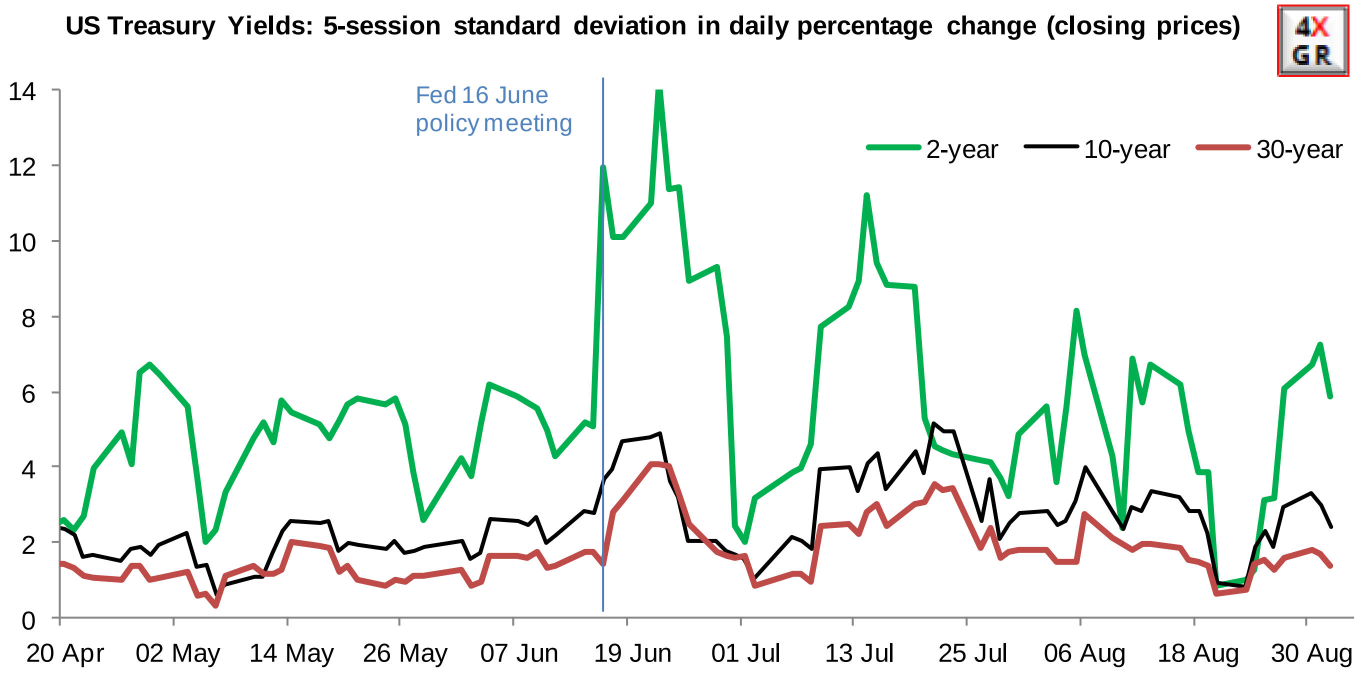


Source: 4X Global Research, Federal Reserve, investing.com

Note: 10-year Treasury yield minus 2-year Treasury yield

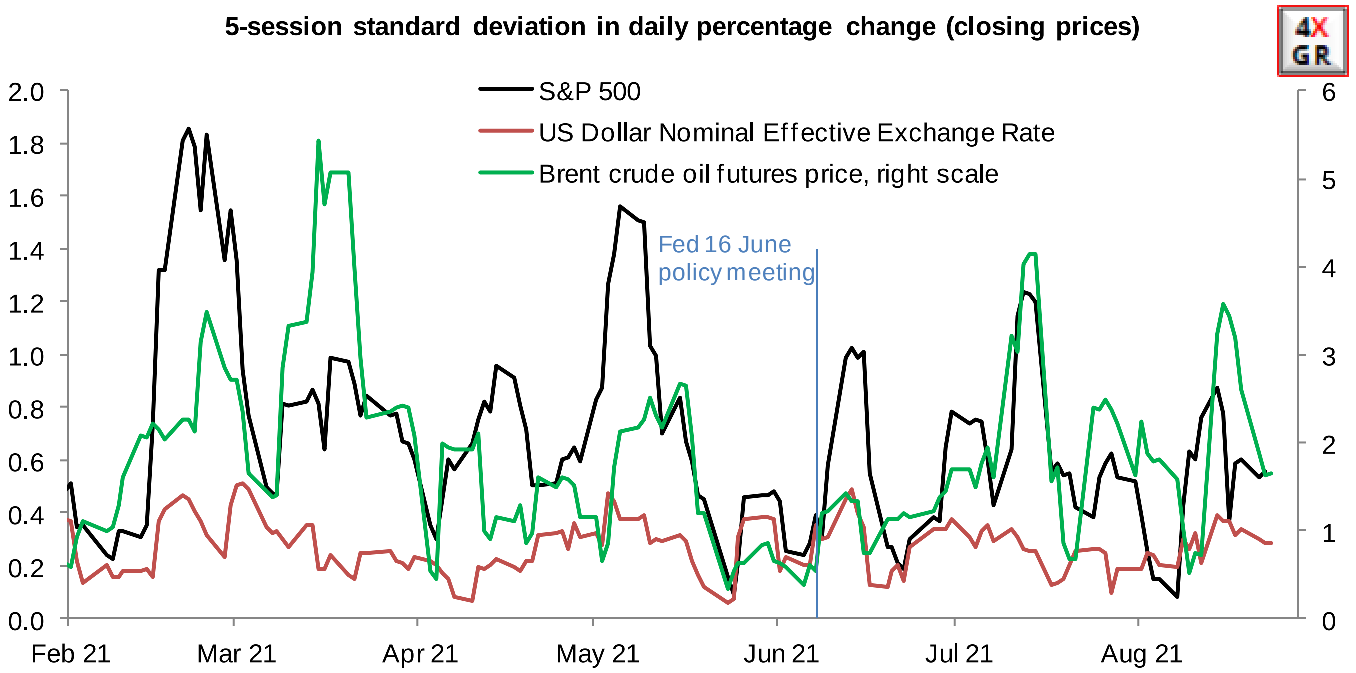
Levels clearly matter but, just as importantly from Powell's perspective in our view, volatility in asset prices, including Treasury yields, the Dollar and S&P 500, has also remained reasonably subdued (see Figures 8 & 9). Even volatility in the price of Brent Crude oil has fallen sharply. Markets wobbled on 16th June and in following days but the Fed would argue that it has since kept markets on a reasonably tight leash and ultimately avoided a repeat of the 2013 taper tantrum.

Figure 8: Volatility in US Treasury yields, particularly in longer-maturities, subdued in recent weeks



Source: 4X Global Research, investing.com

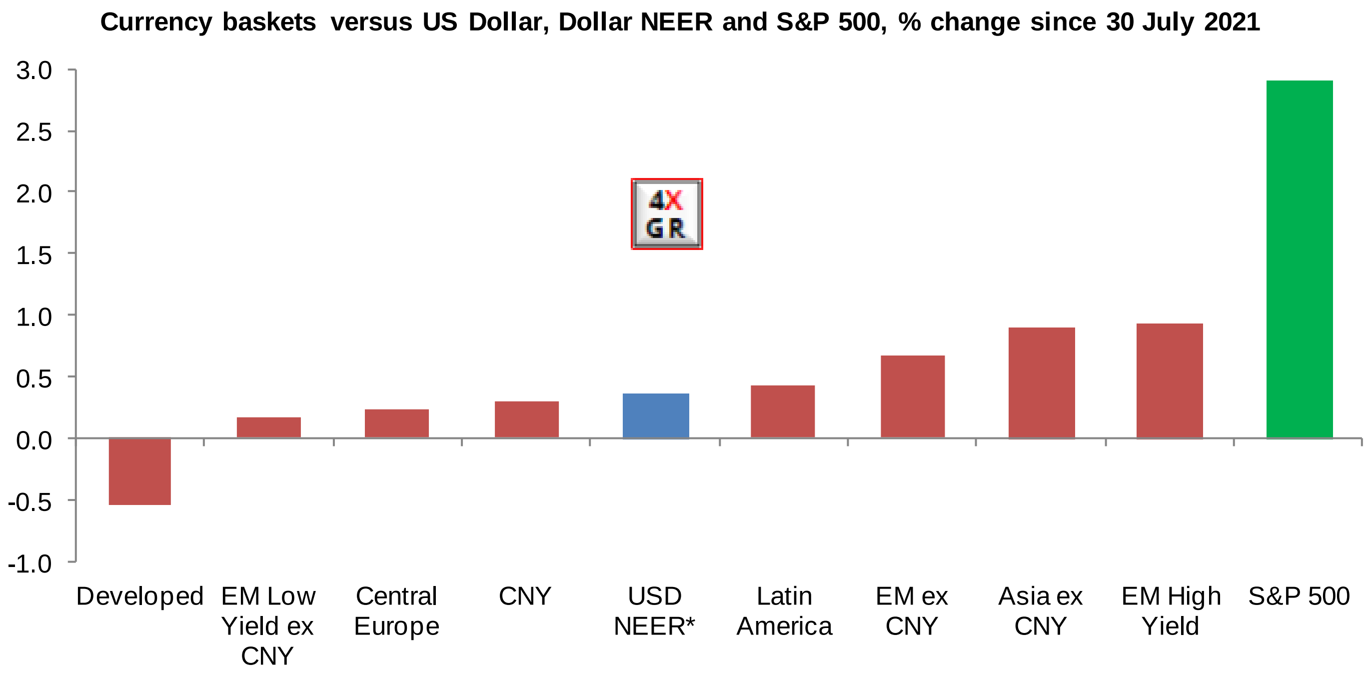
Figure 9: Volatility in S&P 500, US Dollar and now even Brent Crude oil price modest



Source: 4X Global Research, Federal Reserve, investing.com

Finally we would note that, perhaps unsurprisingly given low US Treasury yields and buoyant US (and global) equities, Emerging Market (EM) currencies, particularly high-yielders, have outperformed in the past month. Since 30th July, a GDP-weighted-basket of EM currencies excluding the Chinese Renminbi has appreciated about 0.7% versus the US Dollar, according to our calculations, while a GDP-weighted basket of developed market currencies has weakened about 0.5% (see Figure 10). Within EM currencies, high-yielding currencies (+0.9%) have outperformed low-yielding currencies (+0.2%). Whether this is a "good" thing for EM economies is up for debate. Stronger currencies reduce the local-currency cost of servicing external debt but also weigh on export competitiveness.

Figure10: EM currencies, particularly high-yielders, have outperformed (but still lagged S&P 500)



Source: *4X Global Research, Federal Reserve, IMF, investing.com*

*Note: * USD NEER is US Dollar Nominal Effective Exchange Rate (Federal Reserve trade weights).*

Jackson Hole now old news – next hurdle for Fed/markets is 22nd September policy meeting

There is little doubt in our mind that Powell has taken on board the lessons learnt from the 2013 taper tantrum, namely that even a rational, broadly expected and modest shift in US monetary policy needs to be handled and communicated with great care. However, Powell only had to look back at the Fed's 16th June 2021 policy meeting to be reminded that financial markets' reaction function to even subtle tweaks in the outlook for QE and interest rate policy can be super-sized.

The Fed had until then stuck diligently to a very dovish discourse and been rewarded with a fall in US Treasury yields to multi-month lows despite the release (on 10th June) of data showing that US CPI-inflation had risen faster than expected in May. Moreover, the S&P 500 gained about 0.8% between 9th and 14th June while the US Dollar NEER appreciated only marginally. This was in line with our view that this CPI-inflation release would not be "*the straw that broke markets' dovish back*" (see Have hawks finally lost altitude?, 9th June 2021).

This all changed when the Fed published on 16th June its updated dot-chart which showed that a majority (13 out of 18) of FOMC members now expected a policy rate hike in 2023 (rather than 2024) and Powell admitted during his press conference that the Fed was now "*talking about talking about*" tapering. The Fed also revised materially higher its forecast for average core PCE-inflation, to 3.0% from 2.2% (see Fed: Same game, different rules, 22nd June 2021).

While on the surface these tweaks were arguably benign and/or not particularly surprising, US 2-year Treasury yields in the ensuing week surged to a 15-month high (see Figure 4), the S&P 500 temporarily wobbled and the Dollar spiked higher (see Figure 7). Asset price volatility also ratcheted up (see Figures 8 & 9). The Fed had let the cat out of the bag even if unlike during the 2013 taper tantrum it ultimately managed to keep the cat on a leash. This was in line with our view that "*the Federal Reserve had won the battle, but it was likely to be a long war*" and that "*emerging market currencies' strong albeit uneven rebound remained vulnerable to any spikes in US and other developed market government bond yields*" (see Something has to give, 30th April 2021).

When Powell wrote his speech for Jackson Hole these events would have been still very fresh in his mind…and they should also remain at the forefront of financial markets' thinking ahead of the Fed's next policy meeting on 22nd September.

The Fed will have many August macro data points at its disposal when it meets in three weeks time, including labour market and CPI-inflation figures due out respectively on 3rd and 14th September. A strong set of non-farm payrolls data – the consensus forecast is for + 750, 000 in August – could see the Fed stating more explicitly that it will start tapering its asset purchases before year-end. However, we think that the Fed and Powell may still refrain from giving a more specific and hard-coded timeline and do so only at its 3rd November policy meeting in order to retain a degree of data-dependent policy flexibility.

We also expect the Fed's updated dot-chart to show a further hawkish shift in terms of the appropriate timing for policy rate hikes. Whether in the eyes of investors this jars, even if temporarily, with Powell's disassociation between QE and interest rate policy is open to debate.

Three months ago we set out our core scenario that tapering would only start in early 2022 and we may only be off by a few months (see Tantrum "lite" won't help US Dollar, 28th May 2021). If that proves to be the case the gap between the start of the pandemic (in early 2020) and the start of the taper will have been less than two years. In comparison the Fed only started tapering its QE program in January 2014 – almost six years after the peak in the Great Financial Crisis in 2008. Nevertheless, some perspective is required. Unlike singer/song-writer Tracy Chapman, Powell is not "talking about a revolution" but still only talking about starting to slowly dial back (at a still unspecified date) ultra-loose monetary policy.

Fed policy rate hikes – a compressed timeline but from a very stimulative starting point

We are for now sticking to our core scenario that the Fed will only start hiking its policy rate in 2023 but that the gap between the start of the taper and the start of the rate hiking cycle will be smaller than the 23 months gap in 2014-2015 (see Fed: Same game, different rules, 22nd June 2021). Moreover, while the Fed waited a further 12 months to deliver its second rate hike (in December 2016), we think that this time round the Fed will not wait nearly as long. Ultimately, the Fed's reaction function will be far swifter in our view than in the wake of the Great Financial Crisis in 2007-2009 because the US economic recovery and rise in underlying inflation has been far steeper, partly because of far looser (i.e. stimulative) fiscal policies than in 2007-2009.

The Fed announced at its December 2013 meeting that it would start cutting its monthly asset purchases in January 2014 (from $85bn to $75bn) and had cut them to zero by end-October 2014. However the Fed only delivered its first 25bp rate hike in December 2015 and waited another 12 months to deliver its second. This should perhaps not have come as a major surprise with the beauty of hindsight. At its 19th June 2013 policy meeting, the FOMC dot-chart revealed that respectively only 4 out of 19 members (21%) thought that the Fed should have started hiking rates by 2014. Fast forward to the Fed's 16th June 2021 meeting and 7 out of 18 (39%) FOMC members thought the Fed should deliver the first rate hike in 2022.

Assuming that the Federal Reserve does not hike rates in 2022, it is conceivable in our view that the 7 FOMC members who in June thought that it would be appropriate to do so will push for a policy rate hike in early 2023. It would then only take a further 3 members to think the same in order for there to be a majority (10 out of 18) in favour of the Federal Reserve starting to hike rates in early 2023.

The dot-chart is of course anonymous – individual dots are not attributed to members of which only 12 (at most) have voting rights at any one time. However, it is conceivable in our view that the Fed could start hiking rates in H1 2023, which (assuming that tapering starts in Q4 2021) would imply a gap between the start of the taper and the start of the rate hiking a gap of only 13-18 months this time round.

But again some perspective is required. US monetary policy will likely remain very loose (by any metric) until at least 2023 in our view. The Fed will want to engineer a slow and controlled landing – music to the ears of doves and bulls but arguably a concern for hawks fearful of the Fed and financial markets stalling.

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