Confidence must be earned

Amundi ASSET MANAGEMENT

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Fed tapering begins: mission accomplished

INVESTMENT TALKS

Paresh UPADHYAYA
Director of Currency Strategy, US Portfolio Manager, US

Jonathan DUENSING
Head of US Fixed Income

- ***Taper announcement***: *The Federal Reserve struck a neutral balance between the start of a tapering programme and future plans for interest rate hikes. The Fed declared a formal end to the large-scale purchase programme launched with Covid-19 and preserved optionality for future policy moves based on the future direction of the economy and inflation.*
- ***Inflation:*** *The Fed maintained its view that inflation in the short term is 'transitory', but acknowledged that supply and demand imbalances related to the pandemic and the reopening of the economy have led to sizable price increases in some sectors.*
- ***Economic recovery consolidation***: *The Fed expects that in the longer term, an easing of supply chain disruptions will support economic activity and boost the labour market.*
- ***Market reaction***: *Equity markets rallied to new all-time highs as financial conditions are expected to remain accomodative*.
- ***Investment implications***: *We believe the Fed is underestimating the persistence of inflation and expect US yields to rise and the yield curve to steepen over time.*

The Fed strikes a neutral balance

The Federal Open Market Committee (FOMC) appears to have struck a neutral balance in its November 3 meeting statement and Chair Jerome Powell's post-meeting press conference. The Fed was careful to differentiate the formal start to monthly tapering of the asset purchase programme with future adjustments to the Federal Funds Rate. The Fed maintained the transitory inflation language, but specifically pointed to inflation "factors that are expected to be transitory" rather than inflation as a whole.

FOMC statement: tapering to commence this month

There were some notable changes to the statement. **The most significant change was the widely anticipated announcement to the start of tapering**. The Fed announced that it will pare its Treasury bond buying programme by $10bn each month and its agency mortgage-backed security purchases by $5bn beginning later this month and most likely lasting until mid-2022. From December, they will taper their Treasury purchases from $80bn to $70bn and will reduce their purchases of agency mortgage-backed securities from $40bn to $35bn. The Fed judges that similar reductions in the pace of net asset purchases is likely to be appropriate each month, but **it is prepared to adjust the pace of purchases if warranted by changes in the economic outlook**. This will help preserve optionality for the Fed based on the economy and inflation outlook. They would formally end their large-scale asset purchase programme by June 2022.

"The Fed preserved optionality to adjust the pace of purchases based on the economy and inflation outlook."

Despite much speculation about whether the Fed would drop the word 'transitory' to describe the short-term rise in inflation, the Fed kept its language unchanged, adding that supply and demand imbalances related to the pandemic and the reopening of the economy have led to sizable price increases in some sectors.

Finally, there was a minor downgrade in the near-term economic outlook. The Fed noted that the recovery in the pandemic-affected sectors, but such rebound has slowed recently due to the summer spike in Covid-19 cases. However, **in the long run, the Fed expects an easing of supply-chain disruptions to support economic activity and boost the labour market.**

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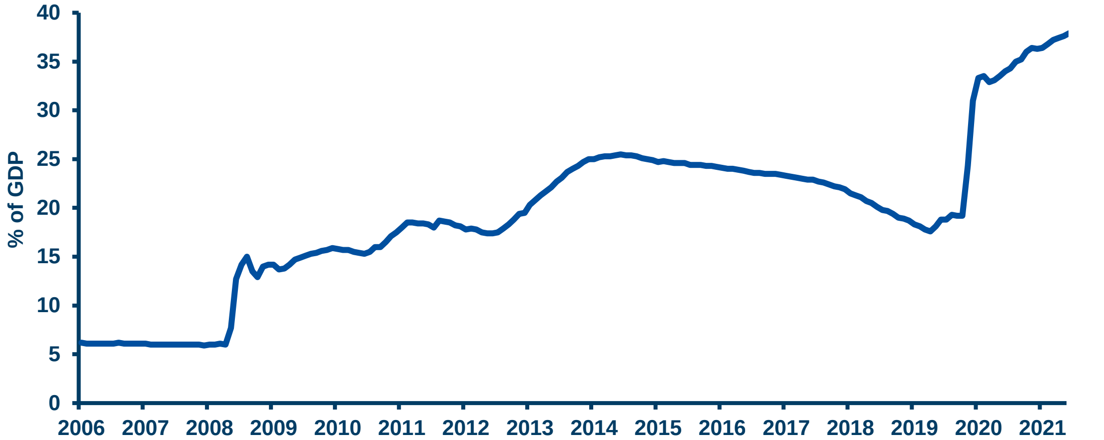
Federal Reserve balance sheet as a share of GDP



Source: Amundi, Bloomberg. Data is as of October 2021.

Press conference: no commitment on timing of rate hikes

The tone of the press conference was balanced. There were four issues that gathered he most attention:

"We believe the Fed is underestimating the persistence of inflation and expect US yields to rise further."

- Chair Jerome Powell highlighted the tapering process and its timetable. He mentioned the Fed will begin to discuss the next move in the balance sheet such as the reinvestment policy.
- There was a lot of discussion on the start to the Fed tightening cycle. The Fed has made it clear that removing accommodation from **tapering its asset purchase programme is the first step before entering policy rate normalisation**. Chair Powell had the opportunity to push back on market expectations which are currently pricing in 2.5 hikes in 2022, but did not. Instead, he stated now is not the time to focus on rate hikes since more progress is needed in the labour market.
- **Chair Powell was a bit defensive towards their transient inflation outlook.** For the first time, he defined *transien*t as *not a permanent move in inflation*, not to be persistent. He gave a time line when the Fed expects inflation to abate, which is the second/third quarter of 2022.
- There was much discussion on maximum employment. The Chairman recognised that in many indicators – including quit rate and job openings -- the labour market is very tight.

Market reaction and investment implications

The equity market rallied strongly as the Fed maintained a balanced tone in its statement and throughout the press conference. Keeping the *transitory* language in describing inflation was interpreted as dovish relative to expectations. Equities rallied to all-time record highs, rising by 0.5-1.0%. The 2-30-year US yield curve steepened. The dollar weakened, as market expectations for rate hikes eased a bit. **We believe the Fed is underestimating the persistence of inflation and expect US yields to rise**. With signs that inflation remains elevated, an expected rebound in economic activity in Q4 and a still patient Fed, we expect the yield curve to steepen. The dollar trajectory is less uncertain, as low-yielding currencies such as the euro, yen, and Swiss franc will struggle to appreciate, while currencies witnessing higher rates by their central banks should appreciate. **Given the combination of higher equities, modestly steeper yield curve with stable credit spreads, overall financial conditions remain rather accomodative. This should please the Fed with the start of its tapering programme. Mission accomplished by the Fed.**

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Definitions

- **Agency mortgage-backed security:** Agency MBS are created by one of three agencies: Government National Mortgage Association (known as GNMA or Ginnie Mae), Federal National Mortgage (FNMA or Fannie Mae), and Federal Home Loan Mortgage Corp. (Freddie Mac). Securities issued by any of these three agencies are referred to as agency MBS.
- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Curve steepening:** A steepening yield curve may be a result of long-term interest rates rising more than short-term interest rates or short-term rates dropping more than long-term rates.
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **TIPS:** Treasury Inflation-Protected Security (TIPS) is a Treasury bond that is indexed to an inflationary gauge to protect investors from the decline in the purchasing power of their money.

Chief editors

Pascal BLANQUÉ
Chief Investment Officer

Vincent MORTIER
Deputy Chief Investment Officer

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