The Federal Reserve Open Market Committee made no changes in monetary policy today, keeping the target short-term interest rate at 0.00-0.25%. Nor was there any change in the pace and magnitude of their treasury and agency mortgage-backed security purchase program ('quantitative easing'). Today's outcome was predicted in CME futures markets at a 97% probability, although the chances for this same policy fell a bit to 90% by year-end, with a slim chance of a quarter-percent move higher by then.

Only a few words changed in the formal statement compared to March's narrative. It acknowledged the degree of economic improvement in recent months, as fiscal policy, reopening, and vaccinations continue to be key drivers. Higher inflation was noted as reflecting 'transitory factors,' and the term 'considerable' when referring to risks was removed.

Economy: Following one of the weakest calendar years for GDP growth since the Great Depression, 2021 is estimated to experience growth at the strongest pace since the early 1980s. We may see growth at an above-average rate in 2022 as well, before it likely settles back into a longer-term secular pattern. The broad and sharp growth recovery hasn't been surprising, and such a rapid rebound would typically push the Fed toward a faster path to normalcy. In this case, the Fed appears to be as sensitive to 'micro' effects as macro—including labor impacts on various populations.

Inflation: Based on the March CPI release, inflation has begun to pick up (year-over-year 2.6% headline, 1.6% core), but not yet to a sustained elevated level. Basing a 12-month result on a low March 2020 starting point accounted for some of this, while generally increasing economic activity, rising commodity prices, sporadic supply shortages, and delivery bottlenecks have also contributed. One of the loudest current debates in the economic and market community is how much inflation we'll end up seeing, and for how long. A rise in short-term inflation has been welcomed by the Fed as it is intended to make up for the disinflationary shortfall experienced prior to the pandemic (with inflation level running well under the 2% target). Consumer inflation expectations have ticked up, but these have increasingly diverged with actual inflation readings in recent years. But one gets the impression the Fed is far happier to see consumers expecting CPI run at 3.5% than at 1.0%, particularly if higher wage inflation coincides with stronger labor markets, especially for lower-wage workers.

Spending to offset the pandemic's economic damage ($5 tril. so far, almost 25% of U.S. GDP) has raised deficit and debt levels not seen since World War II. This, and the Fed's seeming inflation tolerance, has raised worries over potentially higher long-term inflation, such as seen in the 1970s. There isn't a clear precedent to provide guidance, but sustained future high inflation (defined as over 5% or so), does not seem to be the base case of most economists. A variety of long-term structural forces are at play that could continue to serve to depress economic growth and the inflation that can accompany it. These include demographics (aging population, which lowers spending and keeps demand for safety/yield high), weaker worker bargaining power (decline of labor unions), and ongoing advancements in automation and digitalization (which tend to reduce costs).

Employment: Looking beyond the most severe impacts of the pandemic shutdowns starting last spring, the baseline for 'normal' appears to be what the labor market looked like just prior, in early 2020. Standard statistics such as the unemployment rate, nonfarm payrolls, job openings, and jobless claims, have all shown strong improvement over the past few months. But we're not back to 'normal' by any means. With maximum employment as a mandate of the Fed, they're committed to eliminating labor slack, which would warrant keeping policy accommodative for longer (despite concerns over any counter-impacts on the 'price stability' mandate).

In the last few weeks/months, as the economy has begun to reopen and regain steam, there has been an increased divergence in the FOMC member estimates for future policy. This is seen through both the 'dot plots' in the Summary of Economic Projections release, but also in individual comments by Fed members in their speaking circuits. While a handful of officials see 2022 as the point rates will begin to rise, others are less optimistic, still anchored to a 2024 liftoff. These individual point estimates are notoriously subject to change, though, so should be taken with a grain of salt (as Chair Powell has said himself).

Conditions appear status quo for now, but financial markets are keenly sensitive to more durable changes in interest rate levels. This is especially due to their role as an input to risk asset valuation discounting models, and as a main starting point in the perpetual stocks vs. bonds attractiveness debate. Rates have remained low for years due to low overall real economic growth coupled with low inflation (and low inflation expectations), only to surprise by falling even lower due to the Covid recession. Although rates recovered sharply over the last few months, punishing bond prices, they still remain very low overall when viewed from a long-term chart.

The increasingly popular view is that the Fed's window for action is tightening, as they walk a tightrope between keeping the economy stimulated as it recovers, but are able to exit easy policy smoothly before 'too much' inflation takes hold. They're initially relying on communication for this, likely to be followed by a reduction in bond purchases, and then raising rates as a final step. The goal is to avoid surprises, but the risk in such micromanagement is that markets hang on every word, and one misquote or comment taken out of context can raise market volatility. The risks of some type of 2013-like 'taper tantrum' would have to be weighed against the eventual negatives of an economy running 'too hot.' Similarly, markets could react poorly before this if the Fed begins to sound 'too' optimistic, as this threatens the stretch of easy money coming to an early end faster. For now, broad cyclical recovery from 2020's lost year is everyone's primary goal.

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