The Federal Reserve Open Market Committee made no changes in monetary policy today, keeping rates near the zero target of 0.00-0.25%. This was as expected.

The formal statement language was minimally changed. The only adjustments noted labor continuing to strengthen, but have not fully recovered; additionally, economic growth continuing to depend on the path of Covid (which has worsened in recent weeks). The most closely-watched word, 'transitory' (referring to current inflation drivers), was kept intact. Overall, it provided minimal new information. The Fed is establishing two permanent repo facilities, one domestic and one for international transactions. These facilities represent continued non-emergency avenues for providing liquidity to short-term funding markets as needed, rather than being started and stopped, which contain their own market signaling problems. The concept of this had been discussed in prior meetings.

Market analysis has moved to the question of when the Fed will begin (or simply begin discussing) the 'tapering' off of their monthly treasury and agency mortgage-backed bond purchases. Current odds seem to point to year-end, although recently higher inflation readings may have sped up the timeline by a few months.

The Fed's evaluation metrics remain mixed, but point to an economy that is recovering from the worst of 2020:

Economy: Growth in 2021 is expected to be in the mid- to higher-single digits (5-10%), with a gradual flattening toward around 5% in 2022, before declining toward long-term average levels (around 2%) for 2023-24. Of course, much can change in that time. The biggest areas of uncertainty are: (1) the timing of the sharp acceleration in recovery growth reaching a peak, which could be as soon as this past quarter; and (2) the wildcard of surging Covid cases from the Delta variant. Mask-wearing mandates have already been implemented again in some regions, although the majority of severe cases seem to be focused on the unvaccinated. Nevertheless, Covid remains fluid and the pandemic isn't over.

However, it does appear politically less viable for more severe lockdowns to be reinstated—which were the source of 2020's drop-off in activity, along with a hesitancy to travel, socialize, etc. That 'flipping off the switch' of the economy was unprecedented, and damaging. The gap in personal and business income was bridged somewhat by expansive fiscal stimulus, but the appetite for more appears to be waning (as it would add to the already-high mound of U.S. government debt).

Inflation: The trailing 12-month June CPI reading exceeded expectations a bit—to 5.4% on headline basis and 4.5% for core. While the potential length and depth of this inflation episode is being hotly debated, the recovery was expected to generate some degree of inflation pressure, because of extremely low starting points of consumer and business demand, as well as logistical bottlenecks. Some of these headline supply issues are already showing signs of easing, such as in used cars and lumber. A remaining question is about how much of the elevated money supply (such as that measured by M2) will carry into continued general spending sprees and potentially to wages. The Fed has acknowledged recent higher inflation, but still classifies it as 'transitory'. A change in their opinion could certainly be reason enough for today's accommodative policy to be wound down. Historically, inflation has been one of the primary decision factors for global central banks. In fact, a variety of emerging markets have taken the pre-emptive measure of raising rates to stem possible accelerating price pressures (which, at least in modern history, have tended to be more frequent and more disruptive than in developed markets). The Fed has wanted higher inflation, and now that it has it, it remains to be see how much it is willing to tolerate and/or can control.

Employment: The U.S. Fed is unique in the world as being the only central bank with a secondary mandate focused on labor markets. This was put in place during the high unemployment (and high inflation) period of the late 1970s, following political pressure and eventual Congressional action. In pre-Covid times of early 2020, the strong jobs market and low unemployment rate would have been rationale for less accommodative policy under that more narrow definition. However, the bar was raised in an attempt to get unemployment even lower. During the pandemic, though, many economists agree that conditions were extreme enough to warrant easy policy again. But, today, a strong pace of labor repair has some questioning the continuation of that emergency policy. (The same questions were posed in 2008.) While the unemployment rate has not yet moved back to last year's cyclical lows, improvement has shown up in job openings, wages, and other metrics. Some of the remaining divergences, such as skill/regional job mismatches, education levels, and early retirements during Covid, are likely not fixable through short-term monetary policy alone.

All of that said, it appears the Fed's bar for raising rates remains high, despite some disagreement among strategists how appropriate that might be. No doubt, lower interest rates do help the overall U.S. government debt interest burden.

Unsurprisingly, investment markets have been increasingly questioning of a few areas. For one, the rapid pace of recovery growth during the past several quarters was bound to eventually slow. It appears this is happening as we speak, as measured by some deceleration in manufacturing numbers and confidence indexes. By no means does this indicate the recovery is over, or that above-average growth shouldn't be expected for a time. Rather, the market, which tends to look ahead by several quarters typically, is anticipating the business cycle's transition from early- to mid-phase. As noted earlier, the rise of the Covid delta variant has raised worries over a speed bump that could even further slow economic activity. Even while further lockdowns may be politically less tenable, lessened consumer activity could put a wrench in the machine at least.

The U.S. stock market has risen by around 100% from the lows of March 2020. While cyclical factors and sentiment continue to weigh on whether 'growth' or 'value' sectors dominate in a given month, markets rarely move upward in a straight line, and every year has tended to see at least one -10% correction (and several -5% drawdowns). Sometimes these occur for little reason at all, other than prices having become extended. In financial market recoveries from troughs, often initially driven by multiple expansion, subsequent stages have tended to follow earnings growth. Absent a recession, earnings growth remains positive, and that has created a positive environment for equities. (This is especially true of international equity valuations, which are still in the earlier recovery phase.) Despite persistent expectations over the past year for 10-year treasury yields to jump above 2.0%, along with higher inflation and assumed Fed tapering, they have instead fallen sharply due to strong demand for and a limited supply of low-risk assets. The treasury yield curve has flattened as a result, with minimal change in short-term rates. Real estate and commodities have also experienced strong runs, as demand for housing as well as stockpiling of raw materials has continued to help a variety of sectors, including energy and metals.

That said, risk of recession appears low, based on a variety of indicators. The Fed is no doubt mindful of its own history, with sharp interest rate increases being one catalyst for downturns in the past.

Ryan M. Long, CFA
Director of Investments
FocusPoint Solutions, Inc.