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

The formal statement language noted specifically that a rise in Covid cases has slowed the recovery since the June meeting. More importantly, it mentioned a 'moderation in bond-buying pace may soon be warranted.' The committee had been looking for 'substantial further progress' in the economy to warrant such a change. Half of current FOMC members see at least one rate increase by 2022, based on the new dot plot chart. In the economic growth projections, the members downgraded GDP growth assessments by a full percent (moving 2022 higher by a half-percent), almost a percent higher in inflation (although only 0.7% higher for core, from 3.0% to 3.7%), while the unemployment rate projections have deteriorated a bit for 2021. Improvement is expected through 2022-23, however, before reverting to long-term trend around 2024.

The most important topic being looked at this meeting was a hint about the timing of the 'taper'—the Fed's starting point for winding down monthly treasury and agency mortgage-backed bond purchases. The most popular guess from economists had been November, with December a close second. The arguments in favor and in opposition have been mixed, with a seemingly larger pro-taper crowd pointing to the strong economic recovery and inflation readings indicating a need to pull back on loose policy, while the opposite camp notes still-high Covid delta variant cases and job recovery inequality as negative factors, and a caution to not end the easy policy too soon. Then again, the amounts relative to overall supply are not huge, so the timing of a month or two doesn't make that much of a difference.

The Fed's evaluation metrics continue to point to an economic recovery:

<u>Economy</u>: GDP growth in the recovery appears to have peaked in Q2, at 6.6%. Estimates for Q3-Q4 have fallen to a few percent below this pace, to around 4-6%. Initially this was due to waning base effects, but now threats from rising Covid delta variant cases seem to have delayed stronger activity by a few months, including travel plans and office reopenings. Otherwise strong demand has also been held back by supply shortages. Regardless, economic growth has rebounded sharply from last year, and remains at an above-average pace. This strength alone would have likely coerced the Fed to pull back on accommodative policy traditionally, as it appears to be less needed. Recent signs of stress abroad in China, with growth pulling back as well as debt default concerns with property developer Evergrande, for example, may only impact Fed policy to the extent of any global contagion risks. (Evergrande looks to be in a government-led restructuring, alleviating some fears, despite foreign bondholders likely falling last in line.)

<u>Inflation</u>: Price inflation has remained one of the more discussed data points of the year, largely because it's felt more tangibly by consumers—not just theoretically, via 'money supply' or 'average price targeting'. The Fed has stuck to an interpretation of inflation inputs staying temporary this year, blamed on Covid-related supply shortages and demand ramp-up in certain areas. The Fed has softened the language a bit, not on the causes, but on the timing, implying this inflation state could last a bit longer than initially expected. If that's the case, it would be another reason to pull back on easy policy. (Some other nations, particularly in the emerging market group, have already done so.) Inflation running too hot for too long, despite being desired for a time by the Fed, may have a growing negative influence on consumer demand (which is currently strong).

<u>Employment</u>: Labor markets have improved, but not to the degree the Fed would like. There has been debate over the effects of generous jobless benefits keeping potential applicants out of the workforce, particularly on the lower-wage side, but results look inconclusive. Under the Biden administration, the Fed has mentioned 'inequality' more than once in policy discussions, in terms of a secondary aim of closing wealth gaps between demographic groups. However, some economists feel that's more of a fiscal objective best handled by Congress, as opposed to one dealt with using blunt tools of monetary policy. In fact, continuing stimulative policy and lower interest rates has the byproduct of boosting asset prices (e.g. stocks, real estate), which tends to help middle- to high-income cohorts far more than lower-income. The Covid situation still weighs on

month-to-month jobs numbers, although the unemployment and job openings rates have continued their improvement. This trend would also traditionally point to an eventual pulling back of monetary easing.

The Fed has become a victim of its own success in some respects. The QE programs from the Great Recession onward have created a dynamic where financial markets have hung on the Fed's every published or spoken word, and even thrown a 'tantrum' if the mere threat of removing easy policy is not massaged through carefully. Markets have now had a long time to digest the change in direction, and they've been carried higher in the meantime by continued strong corporate earnings results. While no one wants the Fed to end the party by taking away the ultra-loose policy punch bowl, the end is inevitable. If historical precedent holds true, letting loose policy run under the guise of continued weakness could perpetuate too much money flowing to unneeded places—ending in unsustainable asset prices and speculative taking of poor credit risks. Additionally, an exit would help the Fed restock some ammunition to fight other battles down the road, as needed.

As we've already seen this week, the near-term offers the potential for more volatility, as markets digest the timing and magnitude of policy removal, coupled with concerns over peaking growth and what's next. The Fed has been careful in its language, noting that removal of QE doesn't mean interest rates would rise immediately thereafter. All else equal, rising rates change the mathematics of asset valuations by further lowering the present value of future cash flows (and current fair values), while low rates keep fair values elevated. But all is not equal, since earnings have tended to grow more than shrink over time (and at a strong pace lately), so the valuation matter is finding a balance between the inputs.

Autumn has been a volatile time of year from a seasonality standpoint, with September representing the worst individual month over the last century, but October through December by far the most profitable quarter overall[1]. Results this year remain to be seen, with the ongoing wildcard of the Covid delta variant and path to the pandemic's end.

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[1]Per Morningstar/Ibbotson data and FocusPoint Solutions calculations.