The Federal Reserve Open Market Committee made no changes in interest rates today, as expected, staying at the target of 0.00-0.25%. However, this meeting served as the jumping-off point for the 'taper', which had been signaled well in advance of today. The Fed decided to decrease its $120 bil. of monthly treasury and agency mortgage-backed securities purchases by $15 bil. per month ($10b treasury and $5b mortgage-backed), until mid-2022, when all purchases are slated to end.

The formal statement language noted inflation as still 'elevated', and again using the term 'transitory' to describe 'factors' surrounding current demand/supply imbalances. It also showed optimism about these supply constraints improving, to support employment growth and a stronger economy. Noteworthy, the word 'likely' is perhaps more meaningful than normal, implying that the Fed reserves the right to change its view with changing conditions. In a world of Covid, rigidity isn't feasible anyway.

The Fed's evaluation metrics remain mixed (and more fluid than usual):

Economy: A variety of factors have caused the GDP growth rate to slow sharply in Q3 (to 2.0% in the advance report, down from 6.7% in Q2). Looking at the past year broadly, recovery growth in a variety of industries has been strong, and is expected to remain above-average for the foreseeable future as the global economy continues to reopen and move past Covid. However, some hurdles have pushed growth that was expected to happen this year further out into early 2022. Of course, the further this expected growth is delayed, the higher the risk of another disruption in the meantime to derail it. Regardless, estimates from the Fed and a variety of Wall Street economists point to late 2022 or early 2023 as the point at which the recovery bounce fades, and GDP growth rates revert back toward their long-term trend levels of around 2% in the U.S. and 3.0-3.5% globally (the latter being influenced by cyclical conditions in China).

What's behind the recent slowdown? A rise in Covid delta variant cases has hurt (especially in Asia, due to a 'zero tolerance' policy, creating a negative effect on goods manufacturing and shipping activity), as has the mismatch of very high consumer demand and inability to fulfill orders due to logistical disruptions. However, these seem to be slowly easing a bit, with companies creatively working around the traditional large ship+container model, using alternative and unconventional methods such as chartered smaller ships, choosing trains over trucks, etc. This may indeed save Christmas, if there are enough workers to get goods out of the warehouses. But, overall, the high demand and need for labor continue to fuel the inflation spiral. So far, companies have passed on these higher costs to consumers as opposed to letting them eat into margins (bad for consumers, good for stock earnings). Higher energy prices have created a significant headwind as well. Compared to the 1970s, though, the developed economy is less petroleum-intensive today than it was then, so that has been less of a damper to activity.

Inflation: Higher prices remain a primary concern of markets, although more than a few economists agree with the Fed's ongoing assessment that current high inflation rates are 'temporary' (even if they've started to move away from the well-worn term 'transitory'). Taking apart the various components of inflation, into what the Atlanta Fed describes as 'sticky' or 'flexible', would seem to confirm this view. Flexible prices, due to supply and labor shortages, have been spiking and leading headline CPI, PCE, and PPI rates higher. This is not surprising, with high consumer demand coupled with supply shortages, manufacturing backlogs, transportation delays, and higher energy costs leading to bid-up prices for a variety of durable goods—all noted earlier as reasons for a pullback in activity. A focus in the last several decades on 'just in time' systems have saved companies costs and improved efficiencies, but at the cost of far smaller emergency inventories, leaving little buffer to handle disruptions as seen today. On the other hand, sticky prices (which represent two-thirds of the overall market basket) haven't budged much from their 2-3% annual growth range of the past 20 years, but still may. Inflation conditions continue to evolve, with the timeline for expected higher prices extended to at least part of next year in keeping with logistical disruptions improving.

Importantly though, longer-term market inflation expectations (starting in later 2022 and into 2023, for example) have inched back down toward the 2% average. Aside from the bump in growth as the economy has recovered, multi-year labor force growth and productivity remain tempered. These are based on long-term demographics—trends difficult to 'undo'—and are assumed to keep a general overheating of the economy in check. That appears to raise the probability for eventually normalized inflation, as opposed to it staying elevated.

<u>Employment</u>: While the September jobs number disappointed, data including ADP private employment, JOLTs openings, and jobless claims continue to show improvement. The arguably most-focused-on Fed mandate has been labor, with conditions now apparently 'decent' enough to warrant pulling back on stimulus (even though not as good as they'd like them to be before a rate hike). When is it good enough? Economists continue to debate the level at which 'full employment' is reached (it can't be measured in real time), but it can be extrapolated that a variety of Fed members seem to think it's around a 4% structural unemployment rate.

It may not appear to influence policy directly, but the recent stock trading scandal and resignation of two Fed bank presidents has again raised questions of whether government officials should be able to trade securities potentially influenced by policies. It's noteworthy that these activities were not illegal, and similar episodes have happened with government officials in the past. But does the timing undermine trust in Chair Powell, and will he be reconfirmed in Feb. 2022? Or will President Biden choose a more 'dovish' chair like Lael Brainard as well as two similar board replacements? (A dovish tilt to the FOMC could keep policy more stimulative for longer, and raise the odds of interest rates staying dampened.) The Fed chair role should ideally be independent, but being an appointee, no doubt politics tend to get involved at least a bit. Most politicians tend to want easy policy. (We hesitate to again bring up the physical altercation between LBJ and Chair William Martin in the 1960s.)

What about interest rate hikes? At this point, markets appear to be pricing in several hikes from mid-2022 to 2023, at a pace of perhaps 1-2 per year. (Estimates have moved up from an expected initial late 2022 single hike.) While this has spooked some people, the reality would be a fed funds rate moving from 0.00% to about 0.50% by December 2022. That's still extremely stimulative from a historical perspective. Assuming inflation also comes back down to earth by that time, with supply disruptions improving, real rates would still be negative. A scenario calling for more extensive rate hikes might be high and unrelenting inflation, since an improving labor market barreling toward 'full employment' may not provide enough reason to keep pulling in the reins. Other central banks haven't waited, and have started to raise rates outright, or at least have turned 'hawkish', by discussing a change in policy. (These have been led by fears of higher inflation solely; other central banks don't share the Fed's labor mandate.)

Most assume the Fed would like to ultimately get back to 'neutral' policy—when interest rates are neither stimulative nor contractionary—a place we haven't seen since at least before the financial crisis almost 15 years ago. The Fed and markets are no doubt aware of the strong historical relationship between a sharp tightening of monetary conditions (mainly rapid interest rate increases) and the onset of recessions. This scenario has also been one of the primary catalysts for financial bear markets. Neither policymakers nor investors find that palatable. Monetary policy can only do so much, though, with expectations that a corresponding tapering off of fiscal stimulus aid will also help put on the brakes into 2022. As has been the case over the last 18 months, the environment remains very fluid, making predictions even less useful than normal.

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