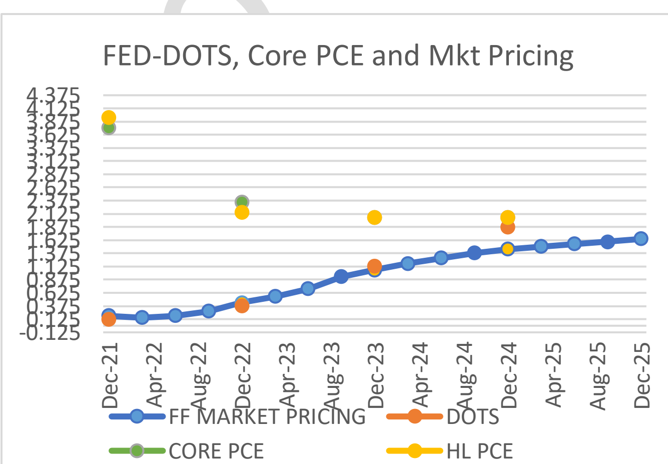
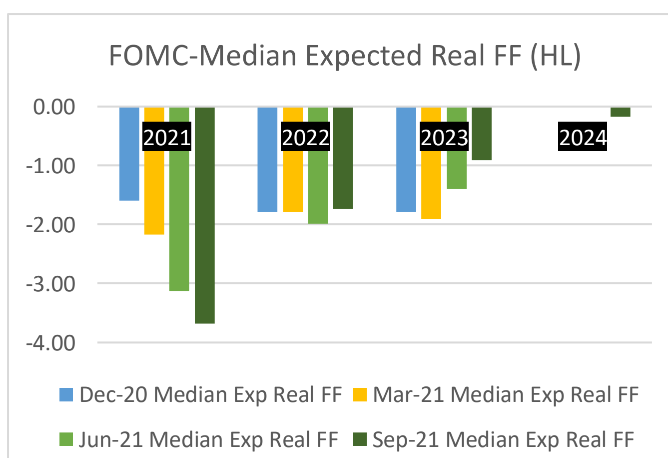
FOMC-Decision and commentary

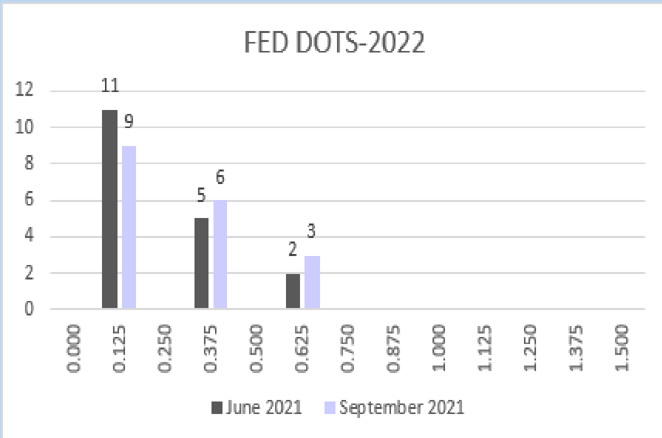
September 22, 2021

Bottom line: Today's FOMC decision was a tad more hawkish than expected by economists and markets. The DOTS resulted in one hike for 2022 vs none in the June projections, 3 hikes in 2023 vs 2 hikes previously and 3 hikes in 2024. Moreover, while markets matched the DOTS for 2022 and 2023 prior to today's decision, they were pricing a little more than 1 hike in 2024; we were delivered 3 (see chart below). On tapering, Powell said -with the usual caveats and hedges- that it would start unsurprisingly in November and his expectation that it would end by mid-2022 was the more hawkish option since it is equivalent to a reduction of USD15bn per month vs a milder move of $15bn per meeting. Powell argues that the faster pace compared to 2013 is justified because the recovery process is much further along, and the board can speed it up or slow it down if conditions warrant it. Despite the hawkish bits, the policy outlook still looks quite accommodative. In nominal terms the FED funds will reach 1.875% by the end of 2024, well below the long-term neutral rate of 2.5%. The real expected FF rate adjusted with Core PCE projections will go from minus 3.5% this year to basically zero/slightly negative in 2024 (see chart below). Powell's message conveyed confidence in the outlook and the timing to start normalization was appropriate. He showed caution about the impact of Covid-19 and put the recent default of Evergrande as a purely idiosyncratic Chinese issue, unlikely to create systemic problems and American companies have very low exposure. He also addressed the impending problem of the lifting of the debt ceiling sending a warning: *"I think we can agree the United States shouldn't default on any of its obligations and should pay them when due and no one should assume that the FED or anyone else can protect the markets or the economy in the event of a failure".* If there is a shutdown or default, the FED will unlikely step in, at least according to Powell. We all know that these are game time decisions. Looking at the projection materials -see charts below- it was clear that there was a serious reconsideration of the inflation outlook and the appropriate policy stance. Perhaps the median DOT doesn't tell the full story; looking at the histogram of projections, one gets a sense that there is more concern about inflation within the board. This may reflect the view that inflation may stay high for longer than the FED wants on account of severe disruptions in the global supply chains which have been amplified by high commodities prices where in some cases -like oil- are the consequence of many years of low investment and are difficult to revert. My takeaways are the FED has started the normalization process in earnest setting a high bar for reconsideration. The dollar is likely to strengthen and will put further pressure on EM and DM central banks to follow suit with normalization. They don't have the luxury that the FED has to do it over multiple years. With very little leeway on the fiscal side long term rates in EM will come under more pressure or will find it hard to rally. I believe that 2022 will be a challenging year for EM.

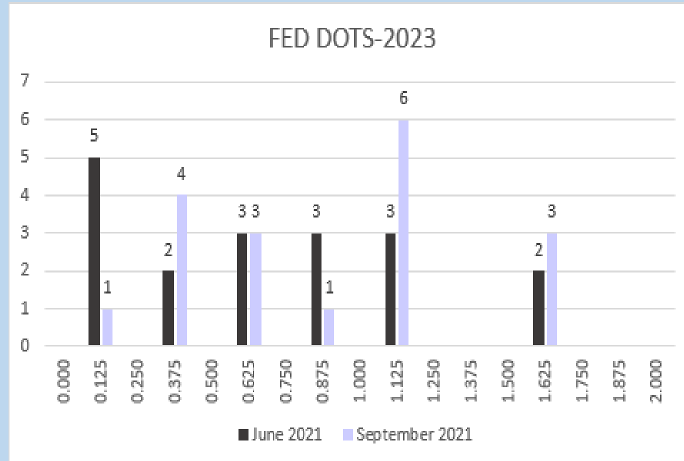




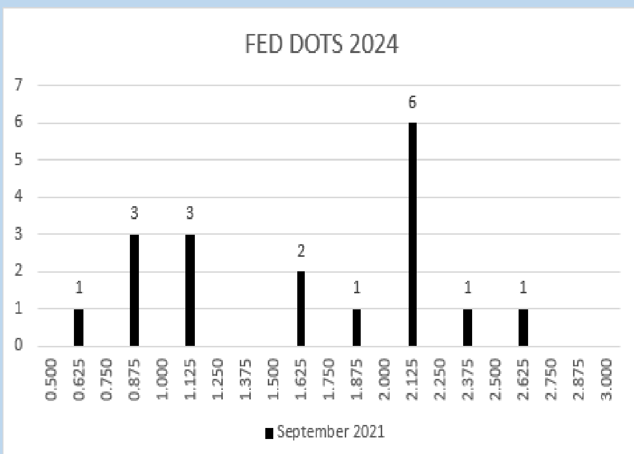
Median 0.375



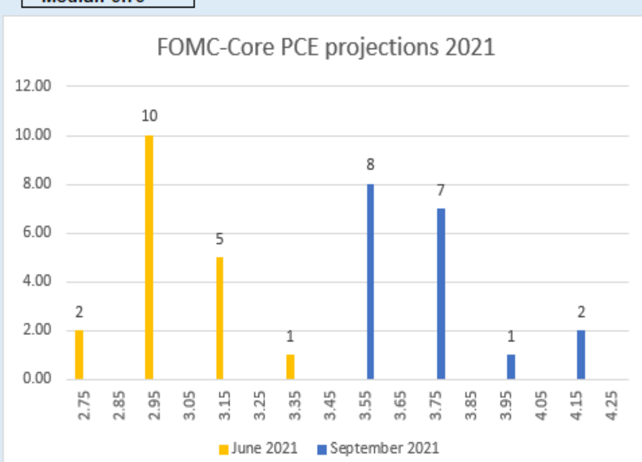
Median 1.125



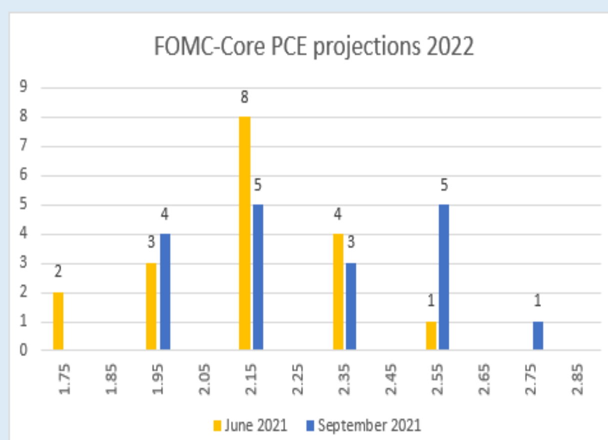
Median 1.88

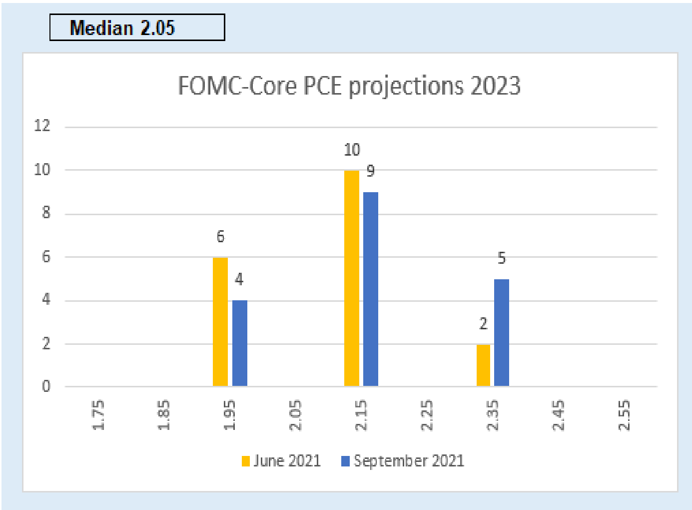


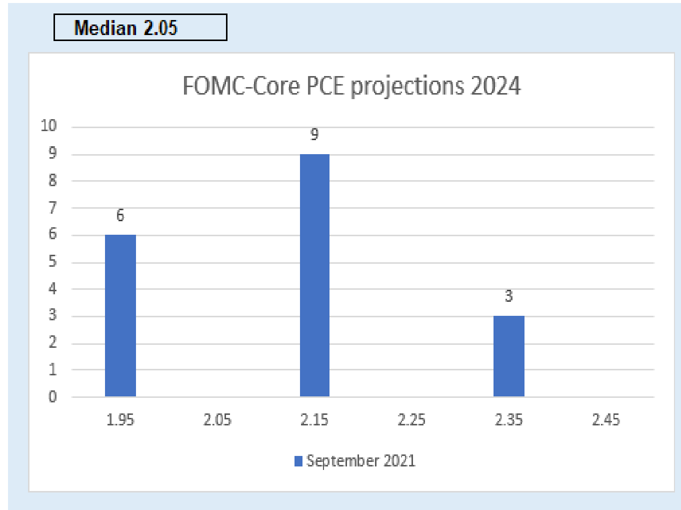
Median 3.75



Median 2.35







Jaime Valdivia
Sovereign Macro
Founder and Chief economist
jaime.valdivia@sovereignmacro.com