Sovereign Macro- FOMC minutes and commentary

October 13, 2021

Bottom line: The minutes delivered little new information. There was broad consensus about starting tapering of purchases soon although there were minor disagreements about how advanced “substantial further progress” was particularly in the labor market. Their assessment of inflation is familiar, it is transitory, reinforced by supply chain disruptions, wages are not exerting pressure, but the risks are on the upside. The behavior of shelter components was specifically mentioned as a potential risk emanating from the large increases in property prices. There is a typical lag of between 6-9 months for rents to reflect higher house prices in addition to the normal indexation practices in the sector. The FOMC broadly agreed that the pace of tapering should be 15bn per month operationally starting in mid-November or mid-December assuming that the decision was made in the November meeting. Opinions were diverse, some wanted a faster pace and others wanted to set the pace according to economic conditions. There was a little bit of scrimmage -albeit premature- regarding the outlook for interest rates. “Various participants” fear that it will be challenging to keep inflation at 2% because they see sustained downward pressures. “A number of participants” worry that inflation will stay elevated raising the possibility of hikes by the end of 2022. I am with the latter camp especially if the FOMC insists on achieving “maximum employment” because it appears unlikely the economy will recover the levels of LFP or EPOP prior to the pandemic. The labor market has fundamentally changed due to retirements, changes in lifestyle, skill mismatches and a substantial stock of personal savings. Moreover, the levels of immunization are already high and incremental progress to unleash labor supply through more vaccinations will be difficult to achieve. Patience to achieve full recovery of the labor market is like waiting for Godot, the labor market is not what it was, and insisting on recovering its former glory only increases the risk of overheating, forget about supply disruptions. This leads me to believe that if the FED insists on putting “maximum employment” ahead of its inflation target increases the chances that inflation will stay persistently high and the chances grow for an early hike in 2022, soon after tapering is done.

Details

- The pre meeting survey of market participants showed that half expected tapering to start in December but also a high percentage saw that it could happen in November; the end of tapering was expected by mid-2022.
- The FOMC staff saw this year’s rise in inflation as transitory. Recent upward deviations were attributed to supply chain disruptions. They expected these constraints to ease partially and import prices to decelerate sharply through next year. HL PCE was expected to move slightly below 2% in 2022 and trend toward 2 by 2024.
- The balance of risks to growth was on the downside and to the upside on inflation with the risk that supply disruptions would be more persistent. The staff also noted the risk that higher inflation expectations would render inflation persistently elevated.

- Risks to the outlook remained despite progress in the vaccination front. The economy is decelerating but growing at a rapid pace. The consumer remains strong supported by a large pool of savings. Some members were disappointed that LFP had not increased as expected after the expiration of the unemployment benefits early in September and blamed it on the resurgence of the virus. This concern was not resolved in the October payroll when the LFP fell, however. Discussions about the slower than anticipated recovery of the labor market were ample. I sympathize with the idea that it is unlikely that we will recover the LFP or EPOP prior to the pandemic when the country has a combined vaccination plus herd immunity that is relatively high (more than 80% conservatively).
- Discussions about inflation included a special mention to rents and OER which was expected to accelerate in response to high property prices. They also noted that there were no clear signs that wages were yet pressuring inflation. They considered that recent measures of inflation expectations were consistent with the FOMC's inflation goal.
- Most participants agreed that SFP of inflation had been met or would be met shortly. The board was divided regarding SFP in the labor market, some said it had not been met but would be met soon and others said that it had been met and a subset of this group noted that adding stimulus considering the nature of the impediments for improvement in the labor market, would be potentially counterproductive.
- They considered illustrative scenarios of tapering at 15bn per month to end by the middle of next year. Some wanted a faster unwind and others stressed that they could adjust the pace depending on circumstances. If they decided to go ahead with tapering in the next meeting, the actual start could be either mid-November or mid-December.
- The board remains divided about the outlook of interest rates. "Various participants" fear that it will be challenging to keep inflation at 2% because they see sustained downward pressures. "A number of participants" worried that inflation would stay elevated raising the possibility of hikes by the end of 2022.

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