Sovereign Macro- FED Minutes and commentary

November 23, 2021

Bottom line: aside from the expected decision of tapering and its pace, there were two main takeaways from the minutes. First, there was a lively discussion regarding inflationary persistence, and second, an emerging debate regarding the future pace of tapering in the presence of elevated inflation. Recent developments including stronger and more widespread inflation readings, a resurgence of the pandemic, robust price surveys and more open concerns about inflation from various committee members, puts me in the camp of those who expect a doubling of the pace of tapering in the December meeting or in January at the latest.

On the first issue, the discussion of inflation persistence, "*many"* thought that inflation would stay elevated because businesses were able to pass higher costs to their customers, and wages had become more sensitive to labor market and financial conditions. "*Some other"* disagreed because they believed that inflationary pressures reflected the same covid related sources but were optimistic they would abate when supply constraints eased, adding that the most sizable price increases may have already occurred and minimized the concern of a developing wage-price spiral that would keep inflation high; they argued that there were in fact already forces pushing inflation lower. Recent wage data and anecdotal evidence coming from important wage settlements challenge the complacent view that the risk of a wage-price spiral should be minimized. Figure 1 below shows a strong response of the wage component of the ECI to a tight labor market shown as the employment to population ratio; the wage component of the ECI closed September at a multi-year high of 4.5% and on a quarterly annualized basis reached 6% in Figure 2. In figure 3, the quarterly annualized increased of AHE is quite similar at 5.5%. Related to the issue of persistence, FOMC members disagreed about the characterization of inflation expectations. "*A couple"* were concerned that "*there were possible signs that inflation expectations were becoming less well anchored",* but "*several others"* dismissed the idea almost outright.

On the second issue regarding the pace of tapering, there were three clusters of opinion. "*Some"* preferred already a somewhat faster pace than was announced (15bn reduction of asset purchases per month) to give the board future optionality to respond to inflationary pressures. Another group of *"various members"* supported a vigilant attitude saying that the committee should be prepared to adjust asset purchases and raise rates sooner than anticipated if inflation stayed higher than desired. I believe that this is the group that is more likely to flip and support a faster pace of tapering considering important information since the last decision including that inflation and wages have been higher than expected with increasing diffusion, the resurgence of the Delta variant pushing inflation higher-as per the minutes' own admission- and that survey-based inflation expectations (Empire State and Philadelphia) reached levels not seen since 1974. The communication coming from several members already shows a growing willingness to at least consider accelerating tapering as early as December. By contrast the group that includes "*a number of participants*" recommended patience to properly assess supply chain developments and their impact on the labor market and inflation.

In terms of communication since the last decision, Bullard has been consistent in calling for hikes in 2022 and a doubling of the pace of tapering as early as December. Clarida moved from saying that the interest rate test (for hiking) would be met by end 2022, to saying that it would be appropriate to consider an acceleration of tapering in the December meeting. Bostic said that it would be appropriate to hike in 2022 and Evans couldn't rule it out when he previously saw hikes only in 2023. And Waller went all out supporting a faster removal of accommodation including a faster pace of tapering and rate hikes. Moreover, he raised a very important issue going forward. He believes that the FOMC should start discussions about reinvestment policy or how and by how much shrink the size of the FED's balance sheet. This will be the important third leg of normalization after tapering and rate hikes at some point in the future. I believe that rate hikes and a reduction in the size of the balance sheet could overlap in time.

Figure 1

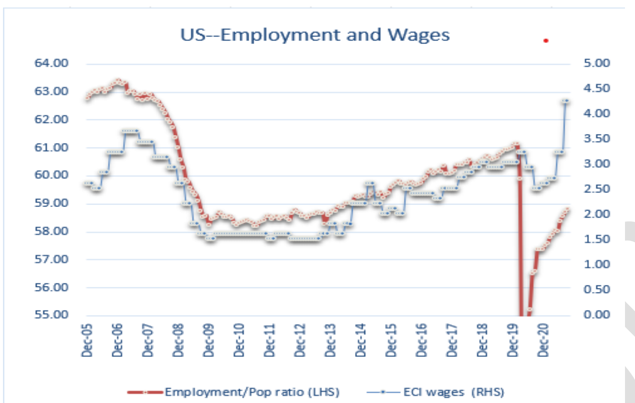


Figure 2

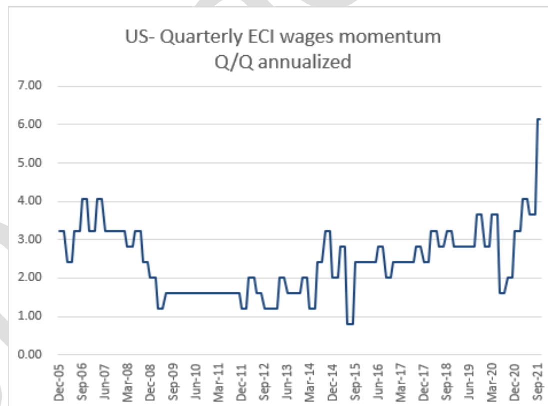
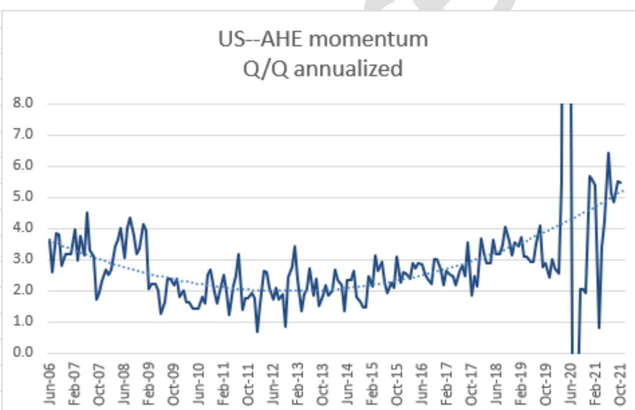


Figure 3



Details

- Delta variant had contributed to the slowdown in q3 by holding down household and business spending, labor supply and intensifying supply chain disruptions.

- Resurfacing of the pandemic slows the shift of demand from goods to services and intensifies problems of supply and reinforces the S/D imbalances and keeps inflationary pressures high.
- Several thought that a structurally lower LFP was possible.
- Participants also admitted for the first time that stronger nominal wage growth and rental costs had been forces adding to inflation. Some believed that inflation had become more widespread
- Uncertainty about the outlook remained high and risks to inflation to the upside which could intensify if Covid worsened
- Participants in general supported the start tapering at 15bn a month. Some participants preferred a somewhat faster pace so that the board would be in a better position to make adjustments especially in light of inflationary pressures. Various members noted the board should be prepared to adjust the taper and raise rates sooner than anticipated if inflation continued to run higher than desired. By contrast, a number of participants recommended patience in order to properly assess supply chain developments and their impact on the labor market and inflation.
- They stressed that would maintain flexibility in their policy adjustments on the basis of risk management considerations.

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