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The Long Glide Path to Liftoff

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The economy is rebounding at a robust and viable pace, and if the pandemic eases significantly, the Fed will be increasingly challenged to explain its reluctance to even "think about" slowing the pace of monthly purchases.

Highlights

- The Fed has maintained its steadfast position that "the ongoing public health crisis continues to weigh on the economy, and risks to the economic outlook remain."
- Expectations are that by late summer tapering will be part of the Fed's discussion if the FOMC sees "substantial" progress.
- Fed Chairman Jerome Powell has stressed that he will give the market a long lead time before the first stage of tightening begins, that is tapering.

THE LONG GLIDE PATH TO LIFTOFF

At the Federal Reserve's Federal Open Market Committee (FOMC) meeting at the end of April, the Fed maintained its steadfast position that despite the successful vaccination campaign, increased government fiscal support, and an economy that is decisively rebounding, "the ongoing public health crisis continues to weigh on the economy, and risks to the economic outlook remain." In terms of an expected bout of inflation, Fed officials have underscored that it will be "temporary," leveling off once supply chains normalize, helping to reduce manufacturing input costs. During the press conference, Federal Reserve Chairman Jerome Powell characterized the economy as being in unchartered territory and said that "we're making our way through an unprecedented series of events."

But when it came to answering a raft of questions regarding the Fed's plans for tapering the $120 billion of monthly purchases of mortgage-backed securities and Treasurys, particularly as the labor market has been healing more quickly than initially projected, Powell reiterated the now-familiar response that "the economy is a long way from our goals, and it is likely to take some time for substantial further progress to be achieved."

More specifically, to a question on scaling back the monthly bond purchases and the Fed's timetable, which would signal the "pivot" in the ultra-accommodative monetary policy that matters to markets, he said: "It is not time yet" to even "talk about" slowing—"tapering"—monthly purchases. Some months ago at the press conference following an FOMC meeting, the chairman similarly commented that the FOMC had "not even begun to think about thinking about tightening monetary policy."

With the forward 12-month P/E (price/earnings) ratio of the S&P 500 sitting at just over 22, the market is stretched compared with its 5-year average of 17.9, and with the 10-year average of 16. Powell has previously emphasized that he agreed that on a P/E basis the market is expensive, but given rock-bottom interest rates, more risk could be extracted from the market, and that rates will remain low for a long time.

The economy is rebounding at a robust and viable pace, and if the pandemic eases significantly, the Fed will be increasingly challenged to explain its reluctance to even "think about" slowing the pace of monthly purchases. According to numerous surveys among economists, expectations are that by late summer tapering will indeed be part of the Fed's discussion if, as Powell has stated, the FOMC sees "substantial" progress. Referring to the nearly 1 million new jobs reported in March, Powell said, "We got a nice jobs report. It's not close to substantial progress. We've had one great report. It's not enough. We're just going to need to see more data. It's as simple as that."

'IT'S AS SIMPLE AS THAT' – OR IS IT?

To be sure, the labor market is still down 8.4 million jobs from its pre-pandemic 3.5% unemployment rate at its February 2020 peak. And with its broadened maximum employment mandate fully embraced by the FOMC, the Fed is going to remain patient until most of the gap is closed. At the same time, Powell has stressed that while the FOMC expects core and headline inflation to climb above 2% in May, it will prove to be "transitory."

Although allowing inflation to rise above its 2% target, Powell stressed in a recent five-page letter to Florida Senator Rick Scott—who questioned the Fed's bond buying program and raised concerns that inflationary pressures were rising—that the Fed seeks to ensure it won't permit a "substantial overshoot of inflation." Moreover, the letter outlined the Fed's strategy concerning inflation: "If progress towards our employment and inflation objectives slows, we will maintain a highly accommodative stance for longer. Conversely, if progress turns out to be more rapid, adjustments to the stance of policy would likely occur sooner."

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a) Over the last couple of months a broad range of indicators suggest a decisive economic rebound, coupled with higher inflationary implications: Allowing for the Fed's focus on the course of the pandemic, the campaign to vaccinate quickly and to reach out to those who remain reluctant, the economy could reach its pre-pandemic growth rate by late summer.

b) First-quarter gross domestic product (GDP) climbed to 6.4% quarter-over-quarter on an annualized basis, bringing the economy to just 0.9% below pre-pandemic levels.

c) Expectations for the second quarter, absent another COVID-19 wave in the U.S., include GDP rising to at least 8.3% on a quarter-over-quarter annualized rate, as the consumer-led recovery accelerates, and consumer confidence remains strong.

d) Initial unemployment claims and continuing claims continue to improve.

e) Wages are increasing, as Amazon raises wages for 500,000 workers and Walmart raises wages for 425,000 employees. Federal contractors will receive a minimum wage of $15 an hour. Workers in food services and hospitality and leisure sectors are being offered signing bonuses and higher hourly wages.

f) The widely followed Employment Cost Index (ECI) for wages and salaries is rising at an annual rate of 4% (1% in the first quarter).

g) Layoff announcements are subsiding.

h) Apartment rents are accelerating.

i) Manufacturing and service sector reports suggest demand and hiring expectations continue to rise.

j) As the earnings recovery continues, capital expenditures are rebounding.

k) The Commodity Research Bureau (CRB) Raw Industrials Index continues to edge higher, as do grain prices.

l) The core Personal Consumption Expenditures Price Index (PCE) is up 4.3% annualized since February. Prices are rising as the reopening continues across the U.S., and as input manufacturing costs climb higher and supply chain bottlenecks persist.

m) Companies have begun raising prices, including Coca-Cola and Procter & Gamble.

CONSTRUCTING THE GLIDE PATH

Expectations are for Treasury yields to inch higher as the underpinning for the economy strengthens and inflationary pressures—"transitory" or not—rise. FOMC members and Powell will have to address their thesis that the stretch of higher inflation will dissipate as the reopening growth spurt normalizes and input costs level off when supply chain bottlenecks are corrected.

The market is going to test the Fed's commitment to its framework and timetable as Eurodollar futures, an important gauge of market interest rate assumptions, have been consistent in pointing to an earlier liftoff for the beginning of interest rate hikes. At the end of April, Eurodollar futures suggest liftoff will begin by the first quarter of 2023, while other gauges point to late 2022. It appears that, given the Fed's unwavering and persistent positioning on being prepared to wait until they are convinced the recovery is thoroughly viable, Eurodollar futures may be too aggressive at this point.

Powell has stressed that he will give the market a long lead time before the first stage of tightening begins, which is the scaling back of monthly purchases, that is tapering. He has also made it clear, perhaps to the market's collective deaf ears, that the Fed's framework or mindset represents an important departure from earlier Fed thinking that the path toward rate hike normalization would begin as soon as the employment backdrop began healing.

The market is factoring in the ongoing vaccination campaign, the reopening of the economy across the country, the continued recovery in the labor market, plus Powell's comment that tapering "would in all likelihood be before, well before, the time we would consider raising interest rates." He has consistently stated that the pandemic-induced emergency support from the Fed would be removed "very gradually."

With the current backdrop, expectations are that by late summer the Fed will begin the taper discussion, and actual tapering could begin in early 2022 and be completed by the end of 2022 or early 2023. If the Fed reduces purchases at the rate of $10-$15 billion a month, the FOMC most likely will pause to assess economic and financial conditions in order to ascertain the exact timing for liftoff.

Just as pilots enjoy a long glide path, abrupt changes can alter the path significantly. Despite the uncertainties outlined by the Fed, there is no doubt plans are now being discussed for various scenarios. By midsummer the market will ask, if not demand, what those plans are. The Fed's "pivot" is one of the most crucial times for global markets, but it's abundantly clear the Fed wants a long glide path toward a smooth liftoff.

References include the following: Associated Press, Bank of America, *Barron's*, Bespoke Investment Group, Bloomberg, CNBC, CNN, Cornerstone Macro Research, *The Economist*, Evercore ISI, The Federal Reserve, *The Financial Times*, Fox News, *The Gartman Letter*, Goldman Sachs, *Kenneth Polcari Newsletter*, Morgan Stanley, *The New York Times*, *Real Money* – TheStreet, Renaissance Macro, Reuters, UBS and *The Wall Street Journal.*

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