SALT INSIGHT

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The September FOMC – a pivotal moment

In months and years to come, as we look back at the history of the upcoming interest rate hiking cycle, we will likely reflect that the September 2021 meeting of the US Federal Reserves' Federal Open Market Committee (FOMC) was the pivotal moment.

Regular readers will know that when it comes to the seemingly endless "transitory versus durable" debate about recently higher inflation, we have been firmly in the durable camp. We have also been of the view that over 2021, many central banks would be bringing forward the timing of ending asset purchase programs and starting to raise interest rates.

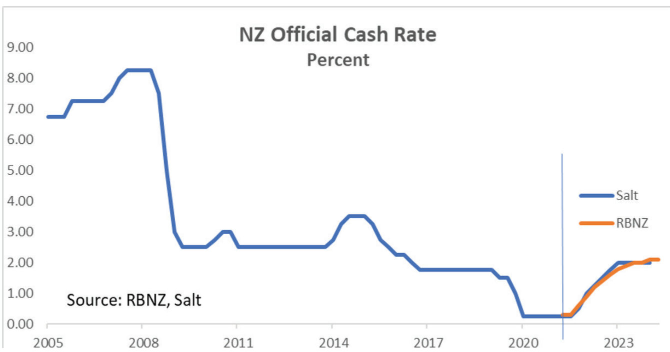
That said, our thinking has been a little more nuanced than whether it would be just one or the other. Of course, as some of the supply shortages and logistical supply chain issues were resolved, inflationary pressures would ease and yes, even reverse. As it has turned out, these supply constraints have proven to be more serious and longer lasting than anybody previously thought.

Our durable argument, however, was grounded in the fast economic recovery following the periods of social and economic restrictions, massive fiscal stimulus around the world that has morphed from pandemic response to general fiscal largesse and the pressure this would put on labour markets and ultimately wage inflation, especially in a likely lengthy period of constrained international travel and closed borders and the obvious implications for the mobility of labour.

Many central banks remain adamant about higher inflation's likely transitory nature. The key information to watch, especially as we monitored their likely shifts in stance from the "dovish" to the "hawkish", was their inflation projections in the latter part of 2022. That is in the window in which monetary policy decisions made today are assumed to have their greatest impact.

The Reserve Bank of New Zealand (RBNZ) view of that near term inflation outlook has changed dramatically over the last few months. In February, the RBNZ was projecting inflation to peak at 2.5% in mid-2021, but then fall back 1.4% by mid-2022.

By August, the RBNZ was projecting a CPI peak of 4.1% in 2021, but to only fall back to 2.2% by late-2022, importantly still above the 2% mid-point of the target range. And that projection assumed a lift in interest rates that was, had it not been for the new Level 4 lockdown, assumed to start with the August 2021 meeting. The RBNZ had made a clear shift from the transitory to the durable camp, and was acting accordingly, even if a little late by our reckoning. We expect two 25bp increases in the Official Cash Rate before Christmas.



Meanwhile, back at the Fed, Chairman Jay Powell continues to argue the transitory nature of current high rates of inflation. But our read of the Summary of Economic Projections (SEP) issued at the time of the September FOMC, including a near-forensic examination of the infamous "dot plot", tells us there is more than a subtle shift underway at the Fed.

In the latest SEP, the average expectation for the unemployment rate in the period ahead continued to decline, but the dispersion of the forecasts is narrowing. We read that as increasing confidence in the improvement in the labour market – the most likely source of durable inflation pressure.

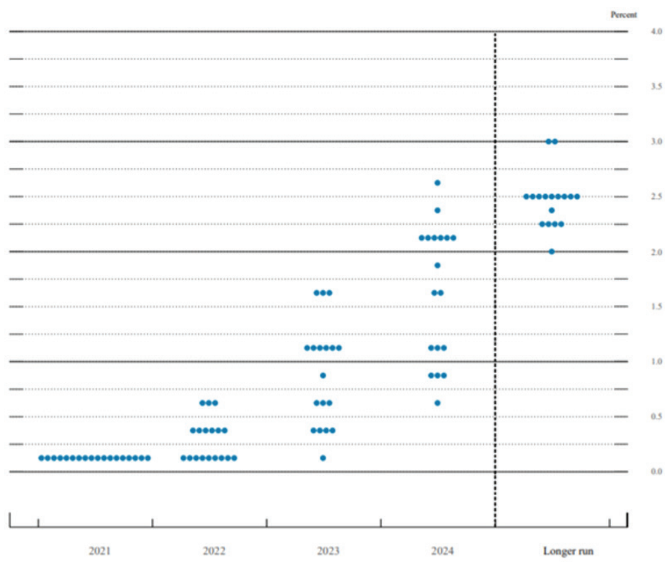
That likely comes from the realisation that while the US labour market is 5.3 million jobs short of the level prevailing just prior to the onset of the pandemic, the problem is on the supply rather than the demand side of the labour market.

Latest data from the Job Opening and Labour Turnover Survey (JOLTS) tells us there are currently 10.9 million jobs waiting to be filled across the United States. That's approximately 0.8 unemployed people for each job opening. That's a problem monetary policy can't fix.

While there is an unusually high degree of dispersion in inflation forecasts amongst FOMC participants, the median expectation is for core PCE (personal consumption expenditure deflator, the FOMC's preferred measure of inflation) to be at 4.2% at the end of this year, but then sustained at above 2% right out to the end of 2024. We think that is a result of the increased confidence in the outlook for the labour market.

A look at the dots for the fed funds rate shows interest rate lift-off nudging slowly forward. In the June SEP there were seven FOMC participants expecting rate hikes to begin in 2022. The September SEP has seen that rise to nine participants (half), with three of them expecting two hikes next year.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



It's notable that it took markets 24-hours to digest the messages within the latest set of statements and projections. The press statement was unashamedly dovish, but this didn't marry with Chairman Powell's comments in the press conference where he said that conditions for sustainable improvement in the labour market had been "all but met".

He also signaled a tapering announcement was likely in November and that the asset purchase program could be expected to wind-up around the middle of next year.

It is clear that at least some members of the FOMC are increasingly feeling the need to get on with the job. A six-month tapering process for this asset purchase program is only half the length of the process to wind up the previous program in 2014.

It's also worth remembering that at his recent speech at the Monetary Policy Symposium at Jackson Hole, Powell went to some length to assure markets that the ending of asset purchases didn't mean that interest rate increases would automatically follow. However, with asset purchases likely to end mid-2022 and with nine FOMC participants now expecting rate hikes in 2022, the gap is getting smaller.

It took a day for bond markets to digest all of this and then gap higher. This was helped on the day by an equally hawkish statement from the Bank of England and the first interest rate hike by the Norges Bank, the first by a developed economy central bank. Also, outside the euro area, another small but indicative rate hike came on Thursday from the Czech National Bank, which ramped up their policy rate by 0.75% in their largest single move in 24 years. Yields have continued to move higher, in part helped by US political tensions around the necessary lifting of the debt ceiling towards the end of October, which will be achieved but not without the usual to-the-last-minute political shenanigans.

Following the mid-year rally because of growth concerns and ubiquitous "technical" factors, we see this latest FOMC statement as the start of the next leg higher in bond yields. We expect to see the yield on US 10-year Treasury's at around 1.8% by the end of the year, with New Zealand 10-year bonds at around 2.2% at the same time.

Equities have a few challenges to navigate in the next few months: rising interest rates, prospects of lower growth in liquidity, flatter earnings growth profile, ongoing regulatory challenges emanating from China and, for the next few weeks, the US debt ceiling machinations.

We have already flagged a "choppier" period ahead for global equity markets for all these reasons. But at the same time, vaccination rates are rising, and while global growth is now coming off its Covid recovery high, overall growth will remain solid. And while interest rates are set to rise, they remain historically low. So, while short-term correction risk is rising, we believe we are still short of the conditions necessary for a prolonged bear market.

However, in this transitional monetary policy environment, it is considered prudent to move assets toward defensive and quality sectors and particularly, companies such as those with reliable and steady cash flows in the health care, IT software & services, and some consumer staples brands. This is precisely the mix of sectors we favour internationally at present.

Furthermore, this environment is conducive of allocations to real assets in portfolios. As a higher path for global cost and price inflation sets in, the global listed real estate and infrastructure asset classes have been shown to deliver real investment performance benefits, notably at times of inflation surprises.