mni

All Signal, No Noise

MARKET ANALYSIS

MNI Fed Preview: January 2021

Meeting Dates: Tue-Wed, 26-27 January
Decision/Statement: Wed 27 January at 1400ET / 1900GMT
Press Conference/Q&A: Wed 27 January at 1430ET / 1930GMT

Minutes: Wed 17 February

Links (likely URLs based on previous meetings):
Statement: https://www.federalreserve.gov/newsevents/pressreleases/monetary20210127a.htm
Implementation note (if applicable):
https://www.federalreserve.gov/newsevents/pressreleases/monetary20210127a1.htm
Press Conference: https://www.federalreserve.gov/monetarypolicy/fomcpresconf20210127.htm

MNI Review of Previous FOMC (Dec): https://roar-assets-auto.rbl.ms/documents/7701/FedRev-Dec2020.pdf

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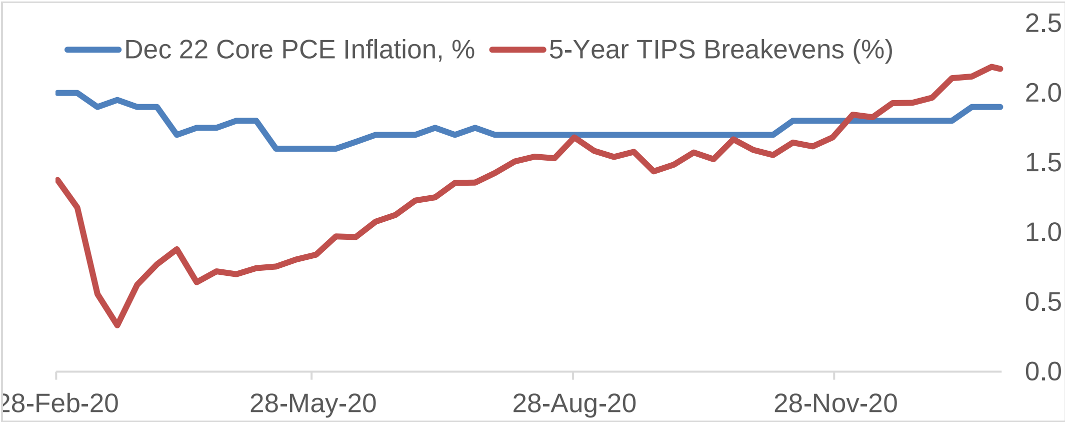
MNI POV (Point Of View): Taper Talk Looks Premature

By Tim Cooper

The FOMC is likely to use the January meeting to reflect on developments over the previous six weeks and assess how they may impact the medium-term economic and monetary policy outlook. But there is little reason to expect the Fed to signal a change of course at this meeting, particularly when it comes to slowing the pace of its asset purchases - as Chair Powell put it earlier this month, “now is not the time to be talking about exit”.

Indeed, the main talking point in January has been the Fed’s tapering intentions. The FOMC introduced new outcome-based forward guidance on QE at the December meeting, which specified that tapering will not begin "until substantial further progress has been made toward the Committee's maximum employment and price stability goals.”

Fig. 1: Survey Of Bloomberg Economists’ Forecasts And TIPS Implied Breakeven Inflation *Sources: Bloomberg, MNI*



Market consensus following the December meeting was that the FOMC would begin to taper sometime in 2022, with rate liftoff following in late 2023/early 2024. But expectations for that timing have subtly begun to shift forward. The Democrats' surprise double-win in the Georgia Senate races appears to have paved the way to larger fiscal stimulus under the new Biden administration, and optimism on COVID vaccines has raised hopes that economic activity could pick up strongly toward the end of 2021.

These developments have boosted analysts' growth and inflation expectations, with core PCE by mid-2022 now seen at 1.9% by the Bloomberg consensus, vs 1.7% prior to the November elections, and 1.8% prior to the December FOMC. 5-Year TIPS breakevens imply 2.2% inflation over that horizon, vs 1.9% at the turn of the year (***Fig. 1***). In turn, we have seen sell-side analysts increasingly eye end-2021 for a potential taper, even if the consensus remains for 2022.

With the criterion of "substantial further progress" remaining vague, the window has been left open for FOMC members to float the possibility of a 2021 taper, including 2021 voters Bostic and Evans in comments in January. This has raised the specter of another 'taper tantrum', and at the very least has let the genie out of the bottle in terms of opening up a broader public debate among policymakers.

But Chair Powell, as well as Vice Chair Clarida, Gov Brainard and others have batted away speculation of an early taper (***see pages 6-8 for Fed communications***), and absent extraordinary upside surprises in the labor market and inflation, the Fed will almost certainly remain cautious on tapering. Medium-term unknowns, including the eventual size and scope of fiscal action, and the effectiveness of the vaccine rollout, will keep the Fed on the sidelines. Even easing can't be ruled out (***as our Policy team notes: "Fed Still Biased Toward More Bond Buying")***. large fiscal package that forces up Treasury yields via issuance concerns could mean that the Fed's attention turns firmly to easing (via extending the maturity of purchases for instance), rather than an exit strategy. In any case, this looks like a premature conversation to have, and the Fed will want to wait until subsequent meetings to take action.

Also suggesting that the Fed will shun tapering for now: FOMC leaders have repeatedly expressed their belief that the labor market has a significant amount of slack to be taken up before inflation becomes problematic (and even so, the new flexible average inflation targeting regime presents a significant cushion before tightening). As our policy team writes, *"current and former Fed officials told MNI the Fed would have to see a significant shift in the economy's trajectory for any unwinding of QE. That kind of shift will not include the expected springtime inflation spike related to year-on-year comparisons bolstered by 2020's weakness."*

Fig. 2: Inflation "Scare" Seen Transient By Economists *Sources: Bloomberg Survey, MNI*

On that front, we could well see an inflation 'scare' in 2021 – though this has largely been telegraphed and would likely be taken in stride by the market rather than renew calls for an early taper. Core PCE inflation is seen by Bloomberg consensus to rise to 1.9% in Q2 2021. But this is being seen as transient and driven largely by pandemic base effects from Q2 2020, with core PCE prices falling back to 1.6% in Q3 2021, only getting back up to

1.9% by Q2 2022. Even if inflation overshoots already-elevated expectations in mid-2021, it's doubtful incoming inflation data will give the Fed impetus to withdraw accommodation anytime soon.

Statement Could Acknowledge Weaker Recent Data, But Powell To Bat Away Taper Talk

It's doubtful the FOMC will alter its statement much from December, though it is possible that there is an acknowledgement of the contraction in nonfarm payrolls in December (for the first time since April) and potentially also regarding disappointing retail sales in December as well. Such a change would apply to the sentence: *"Economic activity and employment have continued to recover but remain well below their levels at the beginning of the year".*

As for the press conference, which will be the most keenly watched aspect of the January meeting, there is little reason to expect that Powell will have much more to say on tapering than in his January 14 appearance. Namely, he is likely to push back against premature taper talk, and repeat that the Fed will be "very careful" to signal "well in advance" its intentions to begin reducing asset purchases.

MNI Instant Answers:

The questions that we have selected for this meeting are:

- Is there a change in the Statement to reflect recent weakness in labor market / econ data?
- Is there a change in the Statement to reflect newly-expected fiscal stimulus?
- Does the FOMC say it plans to shift asset purchases to buying more longer-term securities?
- Does the FOMC raise asset purchases from $120B a month by increasing Treasuries purchases?
- Does the Fed set an interest rate cap, rate target, or range on any part of the yield curve?
- Changes to Interest Rate Paid on Excess Reserves (IOER) / minimum bid rate on overnight repo?
- Any dissents to the decision?

(Formerly Human Readable Algo) The markets team have selected a subsection of questions we think could be most market moving and will publish the answer to all of these questions within a few seconds of the Fed statement being released. These questions are subject to change; clients will be informed of any changes via our Edge and Bullets services. **A comprehensive list of questions is available on the MNI Monitor (available via the website here:** https://www.marketnews.com/realdisplay?product=AFM

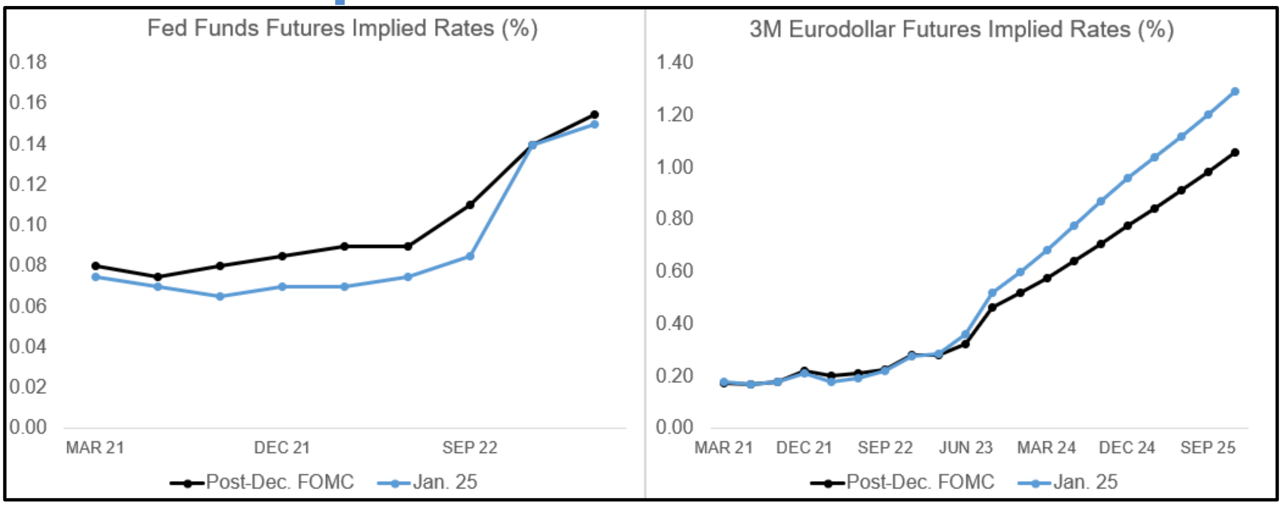
Analyst Views – Fed Outlook

- No changes to policy are expected by sell-side analysts at the January FOMC, according to the 29 notes seen by MNI.
- **While some expect modest changes to the Statement language** to reflect weak December jobs data among other signs of near-term economic weakness, more attention is on the press conference and any comments by Chair Powell on the timeline for the Fed beginning to 'taper' its monthly asset purchases.
- **The broad sell-side consensus** is that tapering will begin in early 2022, with Fed funds rate hikes not before late 2023/early 2024.
- **Largely due to the Georgia Senate results posing upside risks for fiscal stimulus, a few analysts have pulled forward their expectations of Fed tapering / rate hikes since the December FOMC.**
- For example, **Goldman Sachs** now sees the first hike in the 2nd half of 2024 (had seen 2025 previously), while **Deutsche** now sees the Fed beginning to taper by end 2021 (had previously been early 2022), with funds rate liftoff in 4Q 2023 (from 1H 2024).
- The most aggressive call is **Nordea**: tapering to begin in June 2021. The least aggressive is **TD**, which sees tapering starting in 2023 (and Fed funds liftoff not until 2025).
- ***Full summary of analysts` notes, please see pages 9-14***

	Timing Of Beginning Of Taper	Fed Funds Rate Liftoff
ABNAMRO	2022	2023 (2 or 3 hikes over 2023-24)
BofA	Discussion in late 2021/2022	
Citi	As early as September 2021	
Danske	Q1 2022, concluding in Q1 2023	6-12 months after end of taper (i.e. late 2023/early 2024)
Deutsche	Dec 2021 FOMC	4Q 2023
Goldman Sachs	2022	2H 2024
ING	End-2021	2023
JPMorgan	Announced by end-2021	2024
Morgan Stanley	Announced at Dec 2021 FOMC, starting Jan 2022	
NatWest	2022	
Nomura	2022	Not before 3Q 2023
SEB	2022	Not until at least end-2022 "and probably longer"
Swedbank	2022	
TD	Announced at Dec 2022 FOMC, starting Jan 2023	2025
UBS	Announced in Sep 2021	
Unicredit	2022	Not until 2024
Wrightson ICAP	2022	

Correct to the best of MNI`s knowledge as of Jan 25

Market-Implied Rate Outlook



Source: Bloomberg, MNI Market News

- Rate hike expectations have been brought forward slightly since the December FOMC meeting, with money markets pricing in liftoff around September 2023, vs December 2023/Q1 2024 prior. (*Updated Jan 25)*

mni Central Bank Watch - FED

MNI FED Data Watch List

Inflation		Current	3m ago	3m Chg	6m ago	6m Chg	2Y History	Hit / Miss	Vs Trend	Surprise Index	Z-Score
CPI	% y/y	1.4	1.4	→	0.6	↑					-0.21
PCE Deflator	% y/y	1.1	1.2	↓	0.5	↑					0.38
UoM 1-Yr Inflation Exp	% y/y	3.0	2.6	↑	3.0	→					0.76
Inflation Swap 5y/5y	%	2.36	2.04	↑	1.80	↑					1.27
Economic Activity		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
ISM	Index	60.7	55.4	↑	52.6	↑					1.92
Industrial Production	% m/m	1.57	-0.06	↑	6.24	↓					-0.14
Factory Orders	% m/m	1.0	0.6	↑	7.7	↓					-0.06
Housing Starts	K	1669	1437	↑	1265	↑					1.24
Monetary Analysis		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
Corporate Spreads BBB/Baa	bps	1.09	1.52	↓	1.73	↓					-1.35
Chicago Fed Financial Con	Index	-0.63	-0.49	↓	-0.31	↓					-1.24
Consumer Credit Net Chg	$bn	15.3	-8.5	↑	-12.9	↑					0.64
New Home Sales	K	841	977	↓	698	↑					-0.07
Consumer / Labour Market		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
Retail Sales	% m/m	-0.7	1.7	↓	8.6	↓					-0.22
Consumer Confidence	Index	88.6	101.3	↓	98.3	↓					-0.74
Nonfarm Payrolls Net Chg	K	-140	711	↓	4781	↓					-1.06
Average Hourly Earnings	% y/y	5.1	4.7	↑	4.9	↑					0.26
Markets		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
Equity Market	Index	3857	3363	↑	3100	↑					2.36
US 10-Year Yield	%	1.04	0.68	↑	0.66	↑					1.38
US Yield Curve (2s-10s)	bps	92.6	55.7	↑	50.8	↑					1.55
USD TWI	Index	90.82	92.70	↓	91.63	↓					-0.80

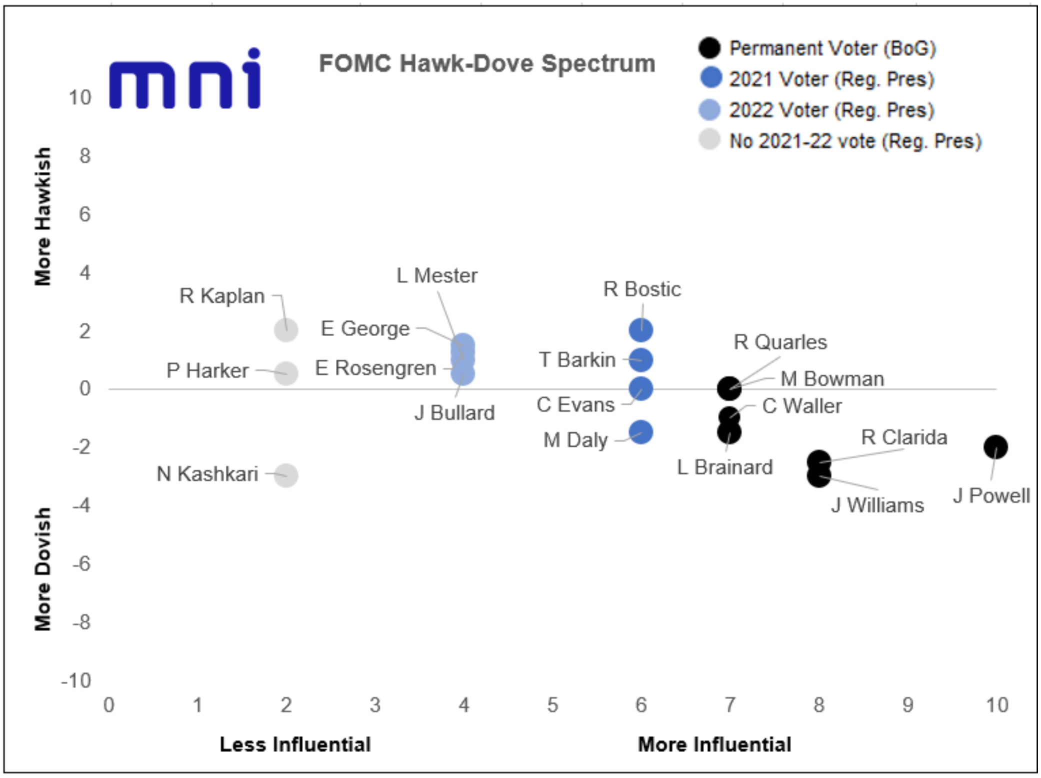
Source: MNI, Bloomberg

- While inflation metrics are off the pandemic lows (especially inflation expectations), and financial conditions/ asset prices are flashing 'green', consumer and employment indicators have been less strong, including a weak December reading for retail sales and nonfarm payrolls. (*Updated Jan 25)*

Key Inter-Meeting FedSpeak – Jan 2021

Here are the prevailing FedSpeak themes since the December FOMC:

- The inter-meeting period's FOMC communications were highlighted by members' speculation on how soon the Fed would tapering its asset purchases.
- Four members noted that they could be open to a taper by end-2021 (Kaplan, Bostic, Evans, Harker).
- **However, the core leadership of the Fed pushed back on such speculation**, with Chair Powell, Vice Chair Clarida, and Governor Brainard signalling that the current asset purchase pace would continue for "quite some time".
- **The key comments in this regard were made by Powell on Jan. 14** (see matrix below) - who emphasized that "now is not the time to be talking about exit".
- **This sentiment was echoed** by several other FOMC members who said it was too early to discuss timing, and/or pushed back against date-based guidance: Rosengren, Bullard, Barkin, George among them.
- **Note this is the first meeting** since the annual rotation of voting regional presidents at which the following members will vote: Richmond's Barkin, Chicago's Evans, Atlanta's Bostic, and SF's Daly, along with new BoG member Waller.



*Our matrix uses the following methodology based on the MNI Markets Team`s subjective analysis. **Hawkish/Dovish scores** indicate MNI`s subjective assessment of each member`s stance on monetary policy. -10 implies member believes aggressive easing warranted; +10 is most hawkish, implies member believes aggressive tightening warranted. Scores around -2 to +2 considered relatively neutral. On **Influence**, the x-axis runs from 0 ('least influential') to 10 ('most influential'). Voters in the current year receive a minimum score of 6; the Chair receives a 10 and Board of Governors members receive at least 7. Those who are not voters in the current year are limited to a score of 4; among them, those due to vote next year receive higher influence scores (rising towards end of current year), and vice-versa.*

Member	Role	Voter		Monetary Policy Commentary Since December FOMC
		'20	'21	
J Powell	BOG, Chair	**X**	**X**	**On asset purchase taper:** ""Now is not the time to be talking about exit...The economy is far from our goals. And as I mentioned a couple times, we're strongly committed to our framework and using our monetary policy tools until the job is well and truly done… We will communicate very clearly to the public and we'll do so well in advance before actively considering any tapering of asset purchases." **– Jan 14** **On rate hikes:** "When the time comes to raise interest rates, we'll certainly do that. And that time, by the way, is no time soon." **– Jan 14** **On inflation:** "At the end of the day the public will need to see us allow inflation to move moderately above 2% for a time before the new framework will be seen as fully credible." **– Jan 14**
J Williams	NY Fed, V Chair	**X**	**X**	**No relevant commentary on monetary policy since December FOMC**
R Clarida	BOG	**X**	**X**	**On asset purchase taper:** "My economic outlook is consistent with us keeping the current pace of [asset] purchases throughout the rest of this year… I think it could be quite some time before we would think about tapering the pace of our purchases the way I look at the data, and I'm relatively optimistic about the economic outlook" **– Jan. 8** **On inflation:** ""The primary determinant of actual inflation is expected inflation…other things being equal, my desired pace of policy normalization post-liftoff to return inflation to 2% -- as well as the projected pace of return to 2% inflation -- would be somewhat slower than otherwise" **– Jan 13** **On rate liftoff: "**I went into this quite skeptical about makeup strategies as a practical tool for central banks. And you'll see that there really is not much of a make-up element in this at all, other than we're not going to lift off until we get 2% inflation for a year" **– Jan 13**
L Brainard	BOG	**X**	**X**	**On asset purchase taper:** "The economy is far away from our goals in terms of both employment and inflation, and even under an optimistic outlook, it will take time to achieve substantial further progress [on dual mandate goals]... Given my baseline outlook, I expect that the current pace of purchases will remain appropriate for quite some time." **– Jan. 13**
R Quarles	BOG	**X**	**X**	**No relevant commentary on monetary policy since December FOMC**
M Bowman	BOG	**X**	**X**	**No relevant commentary on monetary policy since December FOMC**
C Waller	BOG	**X**	**X**	**No relevant commentary on monetary policy since December FOMC**
C Evans	Chic. Fed		**X**	**On asset purchase taper:** "It likely will take years to get average inflation up to 2%, which means monetary policy will be accommodative for a long time...This translates into low-for-long policy rates, and indicates that the Fed likely will be continuing our current asset purchase program for a while as well." **– Jan. 4** [re late 2021/2022 taper]: "It could be the case that things are going a lot better, and we do end up doing some type of tapering [then]...It's too early for me to have a strong judgment on that. At the moment, things are pretty uncertain, and I kind of think it's going to take at least the springtime before I have a firmer view on that." – Jan 7 **On further accommodation:** "We could get to the point where the economy is doing well but inflation is not doing enough, and in fact we would need to do more in terms of asset purchases. That could be the case. It could be the case that we alter the maturity structure of the purchases too, in either direction." **– Jan. 7**
T Barkin	Rich. Fed		**X**	**On asset purchase taper:** "We've given outcome guidance, not date guidance." **– Jan. 11**
R Bostic	Atl. Fed		**X**	**On asset purchase taper:** Re a taper by end 2021, "A lot of it will depend on how the virus and the vaccine distribution goes; but if it goes well, if we learn quickly, I think that there's some good upside [economic growth] potential there" **– Jan. 11** "I'm definitely open to the possibility that we may pull it back sooner than people expect" **– Jan 7**
M Daly	S.F. Fed		**X**	**On inflation:** "I'm not at all worried that there's this run-up in inflation around the corner that we will need to pre-emptively stave off... It's quite possible that we'll see some spikes above 2%, in fact the math of inflation would suggest that we'll get some spikes in the middle of the year, but that's not a victory on price stability." **-Jan. 14**
P Harker	Phil Fed	**X**		**On asset purchase taper:** "I'd like to see inflation moving above 2% or on its path to moving above 2% before I would consider [beginning to taper]...Low unemployment and inflation, that's our dual mandate, but a lot of this is dictated by seeing movement in inflation....Our modal forecast might say that in 2022, with inflation at 1.9% and moving toward 2%, tapering could be appropriate...It is a state-based policy, not a date-based policy." **- MNI Interview, published Jan. 13** "I don't see us paring that back right now or in the near future...I could see, potentially, that occurring at the very end of 2021 or early 2022. But it is all going to depend on the course of the economy, which will depend on the course of the virus." **-Jan. 7**
R Kaplan	Dall. Fed	**X**		**On asset purchase taper:** "These purchases, if they go on for longer than they need to, I worry that they have some distorting impact on price discovery, that they encourage excessive risk taking, and excessive risk taking can create excesses and imbalances that can be difficult to deal with in the future." **– Dec. 18** "My own view is that we should at least be having in earnest the discussion about when it's appropriate to taper...I don't want to prejudge right now, while we're in the teeth of the pandemic, when we're going to get there. But I would hope it might be this year…Once we are out of the woods, and convinced that we're weathering this pandemic and moving forward and making progress, I think it's a lot healthier for the U.S. economy and the markets to wean off these extraordinary actions and this extraordinary stimulus." **– Jan. 11**

Member	Role	Voter		Monetary Policy Commentary Since December FOMC
		'20	'21	
N Kashkari	Minn. Fed	**X**		**On the economic outlook:** "I don't think the economy is more resilient to Covid; unfortunately, I think our tolerance for death is much higher than we thought back in the spring… The end of the pandemic is further away than maybe we thought it was… probably going to be all of 2021" **– Jan. 15** **On inflation:** ""I don't see much risk of inflation shooting way above 2%." **– Jan. 15**
L Mester	Clev. Fed	**X**		**On asset purchase taper:** "A slowdown in the economy in the first part of the year along the lines I am expecting wouldn't require a change in monetary policy so long as the medium-run outlook remains intact." **-Jan. 12** "If things work out the way I hope they work out, I would like us to be able to taper asset purchases next year, but it's going to really depend on the economy." **– Jan. 5**
E George	K.C. Fed			**On asset purchase taper:** ""In the current environment where the economy continues to heal, an accommodative policy stance is appropriate. It is too soon to speculate about the timing of any change in this stance." **– Jan. 12** **On inflation / rate liftoff**: ""If inflation takes off in ways that are unanticipated, that of course will require some decisions to react to that." **-Jan 12**
E Rosengren	Bos. Fed			**On asset purchase taper:** "[I] expect that short-term interest rates near zero will be appropriate throughout this year, and that the Federal Reserve will continue to purchase long-term assets until the economy is on a stronger economic footing... I expect it to be a little while before we're even talking about tapering on our purchases of government and mortgage-backed securities." **– Jan. 12**
J Bullard	St. Louis Fed			**On asset purchase taper:** "There's just too much uncertainty at this point, and it would be inappropriate to try to tie things down to a specific date." **– Jan. 7** **On inflation/rate liftoff:** "We are going to be less pre-emptive than we would have been [in previous times]…we are not going to be preemptive in that sense, we are going to let inflation go over target." **– Jan. 13**

Analysts' Key Comments

Note summaries in alphabetical order of institution. Key abbreviations: Fwd Guidance = Forward Guidance; SEP = Summary of Economic Projections; YCC = Yield Curve Control; AIT = Average Inflation Targeting, WAM = Weighted Average Maturity

ABNAmro: Hikes To Begin In 2023

- **Future action:** Fed to taper in 2022. 2 or 3 rate hikes over 2023-2024 (which will be partly priced in by markets in 2022).

Barclays: Pushing Back On Expectations Of An Early Taper

- Barclays is looking for an uneventful meeting, "as the Fed weighs the degree to which momentum in activity has ebbed against the passage of a federal aid package in late December and building expectations of further federal spending on the heels of Democratic control of Congress."
- They see the possibility of an early taper as a minority view on the FOMC.
- The Fed sees elevated labor slack keeping inflationary pressures muted even if/when activity and employment rebound strongly in the coming year, as Barclays expects.
- **Press conference:** Powell to repeat remarks that any exit to current policy stance is well off in the future and the FOMC is not even discussing such an exit.

BMO: New Voters, New Administration, Same Policy

- BMO expects no change in policy at this meeting, or indeed "those that immediately follow".
- Per BMO: "Once economic activity has freed itself from the vagaries of the virus, or as much as it's going to (allowing for some permanent behavioral changes), the quickness of the FOMC's shift to lessening the degree of policy accommodation or tightening will largely be influenced by another factor, the Fed's new monetary policy framework" – which in turn suggests absent persistently high inflation, "the Fed is not going to pull any prospective policy action forward".

BofA: IOER Hike And Tapering Discussion Later In 2021

- **Future action:** Fed to hike IOER in 2H 2021. Tapering discussion expected late 2021/early 2022.

CIBC: Fed To Stick To Dovish Message

- CIBC says the Fed "will stick to its dovish message" at this meeting, with the FOMC "caught in a bit of a waiting game as it looks for clarity on how much additional fiscal stimulus Congress is willing to approve".
- Given recent speeches by Powell, Clarida etc, no change in messaging expected at this meeting.

Citi: How Far Ahead Is "Well Ahead" For Taper Warning?

- Citi sees little new at the January FOMC, with neither policy plans nor the economic outlook substantially changed since December.
- Overall, the Fed remains very dovish in absolute terms but also relative to other central banks, with a high bar before considering a taper.
- Main focus of market attention will be on any nuances provided by Powell in the press conference characterizing signalling of the start of the QE taper – on whether "well ahead" means 3 months, 9 months… etc?
- **Future action:** Fed could announce tapering as early as September 2021.

Commerzbank: Fed Can Step Aside For Now

- With Biden stimulus coming, "the Fed can step aside for the time being", Commerzbank thinks.

- Press conference: Powell could make asset purchase taper threshold promise “somewhat harder…in line with his recent statements”.
- **Future action:** Taper debate likely to pick up steam again, but Fed to stop this debate through its communications for the time being.

Credit Suisse: Fed To Overlook Temporary Inflation Overshoot

- CS see FOMC policy unchanged this week.
- **Statement:** To reflect slowdown in growth since last FOMC’s assessment.
- **Press conference:** Powell likely to note potential boost from fiscal stimulus but to assert that the current QE pace will remain appropriate for some time given uncertainty over virus and vaccines.
- Powell likely to repeat that the Fed will overlook temporary inflation overshoot (and that the Fed has tools if an unwelcome rise in inflation occurs).
- **Future action:** Inflation likely to overshoot 2% in coming months on base effects, but Fed to overlook this and remain accommodative.
- FOMC to begin communicating their intentions to taper asset purchases well in advance of any policy shift.

Danske: Taper Talk Genie Already Out Of The Bottle

- Danske sees no major policy changes this week.
- **Press conference:** Powell to take questions about the tapering process; to repeat that it’s premature to discuss (though Danske notes that the genie is already out of the bottle in this respect). Powell to welcome Biden’s proposal to expand fiscal policy.
- **Future action:** Fed to “start talking more seriously about tapering in Q4 21, start tapering in Q1 22 and conclude tapering in Q1 23, followed by the first rate hike six to 12 months down the road”. Though the Fed’s data-dependent guidance means this is subject to changes (e.g. if inflation surprises to the upside).

Deutsche: Too Soon For Taper Talk

- Deutsche sees little impetus for changing policy at the January FOMC, with taper talk premature as “though medium-term growth prospects have substantially improved, the realized data have yet to make any progress and in fact have taken a step back”.
- **Statement:** Aside from acknowledging recent softness in data, will be unchanged.
- **Press conference:** To focus on the evolving economic outlook and taper timeline.
- Powell likely to adopt a dovish tone (vindicated by recent data softness), despite upside risks from fiscal stimulus. To highlight that next few months could be challenging, requiring continued Fed accommodation, though medium-term outlook more optimistic.
- Powell to reiterate that it is premature to contemplate potential taper timeline, with fiscal stimulus timing/size uncertain, as well as uncertainty on timing of “herd immunity”.
- Deutsche: Powell “should use some variant of the Committee is ‘not even thinking about thinking about raising rates’”.
- **Future action:** Parameters of QE unlikely to change in near term. But Fed to begin signalling intentions to taper at June FOMC, and to start taper in Dec 2021. Rate liftoff in Q4 2023.

Goldman Sachs: Looking Past The Pothole

- Goldman sees the January FOMC as “fairly quiet”, with Fed officials balancing the recent faltering pace of economic recovery, with a bright medium-term outlook.
- **Statement:** To acknowledge recent negative growth news/worsening virus spread but “to stop short of suggesting any downgrade to the medium-term outlook.”
- One hawkish risk: reference to rise in inflation expectations since December FOMC.
- Press conference: Focus to be on any further comments on taper horizon.
- **Future action:** Goldman’s “best guess” is that tapering begins in 2022, with end-2021 unemployment of 4.5% and core PCE running at 1.85% in early 2022, meeting “substantial further progress” threshold, “though idiosyncratic developments in inflation could tip the balance earlier or later.”

ING: Taper Conceivably By End-2021

- ING sees no policy changes as likely this week, but eyes an update from Powell on how the Fed sees the economic outlook in the wake of new fiscal stimulus and vaccine rollout.
- Newsflow since the Dec FOMC has been positive over the medium/long-term (fiscal; vaccinations), but more negative in the short-term.
- Concerns of the potential impact of fast-rising yields on the recovery "has probably contributed to the Fed dampening talk of possible QE tapering later this year."
- **Press conference:** To retain cautiously optimistic tone, while seeking to downplay the prospect of any meaningful change in policy any time soon.
- **Future action:** ING sees a period of "booming growth, elevated inflation and ongoing fiscal stimulus" which could "conceivably" lead to a taper at end-2021 with a rate hike "on the agenda" for 2023.

JPMorgan: Funds Rate Guidance May Not Change For Years

- JPM sees this week's FOMC as likely "uneventful".
- **Statement:** Fwd guidance on funds rate, "the most important part of the statement", "might not change for years to come, and almost certainly won't change" at this meeting.
- Likely needs to mark-to-market "economic activity and employment have continued to recover" given December jobs data.
- **Press conference:** Doubt Powell will say something interesting.
- **Future action:** Fed to announce tapering by year-end 2021 with unemployment approaching 5%; likely to begin raising the funds rate around early 2024.

Lloyds: Powell To Play Down Taper Talk

- Lloyds sees the Fed looking through the recent slowdown in activity, eyeing acceleration later in 2021.
- **Press conference:** Powell to continue to play down taper talk as premature.

Morgan Stanley: Too Soon To Inaugurate Taper Talk

- Apart from some of the usual January meeting "housekeeping" (new voters, shuffling membership on sub-committees, reaffirming longer-run goals statement), Morgan Stanley sees little change at the Jan FOMC.
- **Statement:** Small changes, may update characterization of current economic conditions to reflect recent softness in jobs and retail sales.
- **Press conference:** Powell to deliver a "steady tone", and focus on the medium-term outlook, remaining cautious about pre-emptively considering withdrawing accommodation, including tapering.
- On fiscal developments, "Powell will welcome the fiscal expansion he has been calling or over many months, and will likely continue to downplay concerns about inflationary consequences", including potential "upside noise" in inflation data over 2021.
- **Future action:** Tapering announcement at the December 2021 FOMC, to start January 2022.

NatWest: Tone Will Continue To Be Dovish

- NatWest does not anticipate a market-moving FOMC, though the overall tone "will continue to be dovish".
- While each FOMC member probably has their own ideas about tapering, since the Dec meeting, there seemed to be a concerted effort among most officials to push back against market speculation about an earlier-than-expected taper in their asset purchases or change in rate stance, and in turn any related "taper tantrum" discussion."
- **Statement:** Few meaningful changes; will probably note softness since Dec meeting.
- **Press conference:** Powell to note significant near-term challenges etc due to COVID despite vaccines.
- Will likely point to labor market/broader economy weakening sharply going into 2021 due to lockdowns, but will also look ahead to eventual recovery amid fiscal + monetary stimulus.
- Powell will likely note that core inflation is still running well below 2% on a 12-month basis.
- **Future action:** Current QE pace maintained through end-2021, taper likely starting in 2022.

Nomura: Could Be Somewhat More Dovish Given Weaker Data Since Dec

- Despite “some amount of disagreement” on asset purchase tepering among some FOMC members since the Dec meeting, Nomura does not expect any major developments this week.
- Notably, core members (Powell/Clarida/Brainard) all suggested the Fed “remains months away from beginning more serious discussions on tapering”.
- **Statement:** Could be somewhat more dovish vs Dec’s optimistic tone, given deteriorating labor market and consumer data.
- **Press conference:** Powell’s comments to largely echo his Jan 14 appearance when he said now not the time to begin talking about an “exit strategy”.
- **Future action:** Fed purchases steady through 2021 before gradual taper in 2022, “but risks skew towards earlier action”. Rate liftoff not before Q3 2023, with inflation remaining the key determinant.

Nordea: Watch For Clues On Powell’s Opinion On The Fiscal Outlook

- Changes to monetary policy stance “highly unlikely” at the January FOMC, write Nordea, but the market will watch for clues on Powell’s opinion on the fiscal outlook and in particular whether further stimulus-related issuance “will have implications for the size or composition of the Fed’s QE programme”.
- Nordea point to the potential reduction in the TGA via fiscal spending or less bill issuance weighing on EFFR, which may at some point prompt the Fed to make a technical hike to the overnight RRP rate.
- **Future action:** Rising inflation by mid-year “will in our view be enough to prompt first 1) speculation about a change of balance sheet policies, 2) ultimately a light attempt to taper purchases already in June. This is clearly before consensus expectations, which do not foresee a tapering process beginning until early 2022.”

Rabobank: Fed May Have To Do More If Economy Does Worse Than Expected

- A sharp decline in economic activity – further to the weak December jobs report – may force the Fed to do more, according to Rabobank:
- **Future action:** “The FOMC is anticipating a near-term slowdown, followed by a vaccine-led acceleration. However, if the economy falls back further than they anticipate, or if it looks like it is going to take longer to get back on track, and fiscal support is not expected to be enough, we may still see the Fed extend the maturity of the asset purchases or step up their pace.”

RBC: Fed Trying To Plant Seed Of Accommodation Withdrawal

- RBC sees “little need to make any material adjustments” at the Jan meeting.
- Statement: Little reason to alter; can mark-to-market the negative Dec jobs report and “rough patch” in economy on resurgent virus, “but that reality should be obvious to most observers”.
- Press conference: Powell to reiterate that the Fed is going to remain accommodative for quite some time.
- However, RBC sees discussion among FOMC members about the timing of removal of accommodation as deliberate:“ Powell’s sticking to his script does not change the fact that his top lieutenant (Clarida) and other members have already started talking aloud about scaling back accommodation at some point. That was not by accident, in our view. We think the Fed is trying to plant that seed now in order to try to buffer any volatility later, even if that tree grows slowly.”

Scotiabank: Tapering Discussion Could Begin To Shift In 2H 2021

- Scotiabank sees a “pedestrian affair” in January compared with the Dec FOMC, with no policy changes.
- Dec Minutes showing “nearly all” on FOMC opposed to extending WAM, and likely to be of same view now.
- Powell, Clarida and other Fed leadership trying to avoid a taper tantrum leading to a premature tightening of conditions that make the dual mandate goals harder to reach.
- **Future action:** Reasonable to expect the dialogue around tapering to begin to shift around 2H 2021.

SEB: On The Sidelines Awaiting Vaccines And Biden Stimulus

- The Fed will remain on hold this week, writes SEB, as “the rollout of vaccines and promises of new massive fiscal policy stimulus means that the Fed can look beyond short-term weakness from the worsening pandemic”.
- **Press conference:** Powell to push back against taper talk and repeat that a rate hike will not come soon.
- He will welcome more fiscal support, and express optimism for the long-term economic outlook despite greater short-term challenges from a worsening pandemic.
- **Future action:** No rate hikes until at least end-2022 “and probably longer”. No taper through 2021, but most likely starting in 2022.
- The Fed could accept higher yields if they are driven by rising inflation expectations and/or an improving outlook; but an issuance-induced rise in real yields could cause the Fed to ease policy.
- As a first easing step, The Fed would increase the duration of purchases, possibly while also increasing the share of Tsys from the current $80bn in the $120bn in purchases.

Societe Generale: Fed To Reiterate Cautious Stance

- SocGen sees the Fed reiterating its “cautious stance on the outlook”.
- Fed speakers have made it clear over the past couple of weeks that they do not see the need to taper asset purchases until early 2022 (expecting the economy to recover in 2H 2021), and are willing to let inflation run above 2% to achieve FAIT target – meaning rates are likely to remain at zero “for the foreseeable future”.
- **Press conference:** Powell likely to reemphasize that the heavy lifting on stimulus has to come from the fiscal side.
- **Future action:** Fed is better off using WAM extension in future if rates rise too high too quickly, or consider an operation twist if it wants to curb the growth in excess reserves.

Swedbank: Focus On How Fed Perceives Fiscal Policy

- Though there will be no changes in policy at this meeting, Swedbank sees focus on how the Fed perceives “the new game in town, namely fiscal policy”.
- **Statement:** To continue to say that the course of the virus will determine future activity.
- **Press conference:** Don’t be surprised if it’s more dovish than the statement.
- Powell may stress the need for continued accommodation, a readiness to act, and that the Fed isn’t aiming for tightening policy any time soon despite more fiscal support.
- **Future action:** Tapering won’t occur until 2022.

TD: Tamping Down Tapering Talk

- TD sees the theme for this week’s meeting having set by Powell’s Jan 14 comment: "Now is not the time to be talking about exit."
- **Statement:** No major change in tone, though will highlight net weakening in the economy, even with strength of the recovery to date.
- **Press conference:** Powell to sound “quite dovish” on policy “even as he highlights reasons to believe that growth should be fairly strong in the year ahead”, with inflation “key” to when Fed’s exit begins, and highlighting recent growth/jobs weakness.
- Powell will probably warn that "the next few months are likely to be very challenging."
- Will once again state that QE could be made more accommodative via WAM extension/size of purchases. No new specificity on “substantial further progress” though, and “he will avoid being pinned down on timing for either tapering or tightening beyond suggesting that neither is imminent and that tightening is unlikely until well after tapering begin”.
- **Future action:** TD is “skeptical” that inflation data will justify tapering by early 2022.
- Taper to be announced in Dec 2022 taking effect in Jan 2023; rate hikes not until around the start of 2025.

UBS: Waiting For The Dust To Settle

- **Statement:** To mark-to-market the first para to "highlight the pothole in the economy". But to avoid referring to new fiscal stimulus/vaccine rollout, as will want to avoid tone being seen as too optimistic.
- **Press conference:** Along w statement, Powell will likely want to acknowledge near-term softness in the economy "to push off any further speculation on the timing of a taper".
- Powell to reiterate the need for fiscal support; note that vaccine outlook hopeful but still a long way to go.
- Doubt any clarity will be given on threshold for tapering QE. The point of the asset purchase guidance is for the Fed to have optionality "and to forestall a tantrum".
- **Future action:** Taper announcement to come in September 2021 as the Fed to be surprised to the upside by the economic recovery.

Unicredit: On Hold With Economy Far From Fed's Goals

- Unicredit sees it as "very likely" the Fed will leave policy unchanged in Jan, with the economy "still far from meeting the Fed's goals and, hence, any discussion of tapering is premature".
- There are two main reasons Unicredit sees for the FOMC to remain on hold well into the economic recovery: the revised framework/guidance, and tying asset purchases to economic outcomes.
- Despite some FOMC members mentioning that a discussion on tapering could come this year, Powell and others poured cold water on this.
- While inflation may pick up in 2021 due to base effects etc, Powell and others see this as transient, and Powell has noted that "one of the key lessons from the 2008-9 financial crisis is not to remove policy accommodation too soon, both fiscal and monetary. And given the high uncertainty surrounding the economic outlook, the Fed is likely to err on the side of caution."
- **Statement:** To weigh the current slowdown in economic activity with the more positive medium-term outlook (vaccines, fiscal stimulus).
- **Future action:** Fed purchases steady at least through 2021 but taper could start as soon as H1 2022 "if all goes well with mass vaccination", though net purchases would continue at least through 2022. Rates on hold "at least through 2023".

Wells Fargo: Fed Could Provide Guidance On Tightening

- Wells Fargo does not expect any change in policy at this meeting, but the FOMC "could potentially provide some guidance on the conditions that will be needed before it starts to wind down those programs".
- While the elimination of 13-3 programs "does not have a major impact on our baseline forecast, it does create some small but clear tail risks to the downside".
- **Future action:** No change to IOER at this meeting, but potential for one or more tweaks at some point in the next 6 months.

Wrightson ICAP: Fed Comfortable With View That Next QE Change Will Be Hawkish, Not Dovish

- Wrightson ICAP sees FOMC members having painted "a fairly clear picture of the Fed's balance sheet views" last month.
- The qualitative QE guidance does not rule out possibility of taper this year, but "in practice", comments from Powell and Clarida "should reinforce the market's belief that tapering is unlikely before 2022."
- The median estimates in the Dec SEP might be enough to meet the "substantial further progress" hurdle to tapering, but Powell emphasized that the Fed does not intend to tighten prematurely.
- Communications about balance sheet and front-end rates "are closely related", as when the Fed begins to taper, it will already be looking ahead to managing lift-off expectations. So Wrightson ICAP sees "the best way to persuade the market that the FOMC won't be trigger-happy about raising interest rates down the road is to be conspicuously patient about launching its QE winddown".
- That said, "the FOMC seems comfortable with the view that the next change in its QE program will be hawkish rather than dovish."
- **Future action:** Recent comms suggest no taper through end-2021, but the impact of the taper "still seems likely to show up in the latter part of this year" via announcement/ anticipation effects. Fed likely to "start actively telegraphing" a 2022 taper by 4Q 2021 "at the latest", with markets pricing it in even earlier.

MNI Policy Team Insights

MNI STATE OF PLAY: Fed May Underline Patient QE Plan (Pub. Jan 25, 2021)

By Jean Yung

WASHINGTON (MNI) - The Federal Reserve is expected to keep buying USD120 billion in Treasuries and mortgage assets a month and hold a near-zero interest rate Wednesday while looking for evidence that new fiscal relief and wide dissemination of Covid vaccines are bringing palpable improvements to jobs and inflation.

Since their December meeting, risks have shifted more to the upside on the back of additional fiscal support and the prospect of millions getting vaccinated by summer. However, Fed officials have repeatedly warned of the lasting drag from the virus that has killed 400,000 Americans and reduced employment by 10 million.

Despite a flurry of talk about beginning to taper asset purchases as soon as this year, current and former Fed officials told MNI the Fed would have to see a significant shift in the economy's trajectory for any unwinding of QE. That kind of shift will not include the expected springtime inflation spike related to year-on-year comparisons bolstered by 2020's weakness.

The FOMC added specific forward guidance on its asset purchases at its last meeting, saying that "substantial further progress" in the economy is needed for paring back asset purchases. Sources said policymakers are likely to leave the guidance in place this week. Fed Chair Jay Powell may stick to that tight script after the varying messages about tapering from other officials helped helped push up Treasury yields and risk driving further spikes in coming months.

--RECOVERY TRACTION BEFORE TAPER

"Now is not the time to be talking about exit," Powell said Jan. 15. "We're strongly committed to our framework and using our monetary policy tools until the job is well and truly done."

The Fed welcomed the USD900 million relief legislation passed last month and have signaled their willingness to accommodate the boost without moving rate hikes forward. President Joe Biden is also seeking another USD1.9 trillion package, though negotiations with Republicans may mean a smaller amount is authorized. Officials are committed to seeing inflation reach 2% before lifting rates from zero.

"Rather than tapering early, and potentially prematurely, and assuming the recovery really gains traction once the vaccine is widely distributed, I hope the Fed will instead return to the question that was at the top of the agenda on the eve of the COVID-induced collapse," former Fed Board research director David Wilcox told MNI. That issue was "whether the economy can sustain a higher level of employment now-- without generating undue inflationary pressures -- than previous estimates suggested," he said.

"Particularly with the recently declared intention to tolerate a mild inflation overshoot, the institutional patience to explore that question should be there," he said.

--'VERY SERIOUS SITUATION'

Meanwhile, the U.S. health threat remains a "very serious situation," according to the country's top infectious disease expert Dr. Anthony Fauci, who's advising Biden on his national pandemic response. The latest economic data has disappointed, with the labor market losing 140,000 jobs in December and retail sales hurting as restaurants, bar, hotels and entertainment venues shut down.

December's USD900 billion aid package boosted unemployment benefits and sent more checks to lower income households. Biden's proposal could see cumulative cash payments upped to USD2,000 to support household spending.

The Fed's policy statement is not expected to mention fiscal policy, but officials are certainly eyeing a clearer path for the recovery. Powell also holds a press conference Wednesday where he may expand on QE and fiscal policy changes.

MNI INTERVIEW-Harker Wants Inflation Over 2% Before Taper Talk (Pub Jan 13, 2021)

By Jean Yung

WASHINGTON (MNI) - Federal Reserve Bank of Philadelphia President Patrick Harker wants to see inflation heading above 2% before possibly dialing back asset purchases, calling for patience as the economic rebound from the coronavirus pandemic accelerates this year, he told MNI in an interview Wednesday.

"I'd like to see inflation moving above 2% or on its path to moving above 2% before I would consider" starting to taper purchases, Harker said. "Low unemployment and inflation, that's our dual mandate, but a lot of this is dictated by seeing movement in inflation."

Hanging dates on the milestones for reaching the inflation goal or tapering QE is difficult at this point given the uncertainties of the Covid vaccination campaign and when communities might achieve herd immunity, he said. It could be later this year or next year, he said.

"Our modal forecast might say that in 2022, with inflation at 1.9% and moving toward 2%, tapering could be appropriate," he said. "It is a state-based policy, not a date-based policy."

--POTENTIAL Q1 GDP DECLINE

The Fed is buying at least USD120 billion a month of debt as it seeks to hold down yields with its policy rate already set near zero. Some FOMC officials have signaled they want to begin discussing QE tapering later this year, citing a potential economic surge as vaccines are distributed.

The Fed should make as few moves as possible between now and the winding down of the pandemic, Harker said. That could mean holding on even if the economy shrinks again this quarter amid record Covid cases, and if inflation gets a boost after last year's weakness.

"Given the signals we're seeing, we could potentially see some negative growth in Q1 this year. That's concerning, but understandable given this rapid resurgence of the virus," he said.

Philadelphia Fed economists expect a burst of activity in the second half of the year to make up for weakness in the first six months. With the new USD900 billion fiscal package and trillions more promised by President-elect Joe Biden, growth could hit 3.8% this year and unemployment fall back to 5.8% by December. Inflation is expected to "creep up to 2%" by 2023 "then start to overshoot, but not out of control," Harker said.

--INFLATION 'SCARE'

As low inflation readings of last spring drop out of the 12-month calculations, "there could be an inflation scare, but we have to look through that and not just take one spike in inflation as a signal to take action," Harker said.

"I take my own forecasts with several grains of salt here. So I think we just need to be cautious," he said. "Let's not remove accommodation too quickly. Let's just take our time, until we see the signals that we want to see in terms of unemployment and inflation."

Employers in the Philadelphia Fed district continue to report difficulty finding workers, while many firms are contemplating how Covid will reshape their industries, Harker said. Business supplying other firms, especially in travel and commercial real estate, are "significantly concerned."

Policymakers should try to "save as much of the economic infrastructure as we can" by providing a fiscal bridge for businesses and ensuring eviction bans are in place, he said. Over the longer run, regional Fed banks can play a role in shepherding workers to new jobs.

--'HUMBLE AND PRUDENT'

The natural rate of unemployment may have shifted over the course of the health crisis, and "this is why we need to be humble and prudent when it comes to policy, not making certain moves in any direction," Harker said.

Before Covid, "we were getting unemployment lower than a lot of us, including myself, thought was possible without inflation running hot. So I think trying to get back to that world is a reasonable strategy," he said. "We put a policy in place to start to heal the economy and then watch carefully and see how inflation evolves."

MNI EXCLUSIVE: Fed To Keep QE Pace Despite Bigger Fiscal Boost (Pub. Jan 22, 2021)

By Pedro Nicolaci da Costa and Evan Ryser

WASHINGTON (MNI) - The Federal Reserve will keep up its monthly USD120 bond buying for the foreseeable future despite a much-larger-than-expected fiscal stimulus plan from the Biden administration and muddled public messaging from top policy makers which has helped push up Treasury yields, current and former central bank officials told MNI.

The Fed would have to see a significant shift in the economy's trajectory -- well beyond an expected springtime inflation spike related to year-on-year comparisons --for any tapering of QE to begin later this year or even early in 2022, they said in interviews. That's especially true, the sources said, given the central bank's recent framework shift, under which it committed to make up for periods during which it undershoots its 2% inflation target.

Fed officials have offered mixed public messages about the timing of a potential decrease in the pace of asset purchases, but as MNI reported last week the Fed is not inclined to offer more specific guidance on the trajectory of its asset-buying. Instead, sources say, officials are leaning toward the view expressed by Fed Chair Jerome Powell and other board governors that it's too soon to discuss the timing for unwinding QE.

"This is a good test for their new framework. Prior, you would have expected some pre-emptive tightening, as the forecast for unemployment and GDP moved upwards," said Jeremy Stein, former Fed board governor and chair of Harvard's economics department.

"But now, if you take them at their word, it is less obvious-they are basically saying they don't believe in the Phillips curve, and will wait to actually see the realized inflation before adjusting policy," Stein said.

This is not to say that the process will always be smooth, however, as recent market confusion regarding the Fed's messaging suggests.

--FISCAL BAZOOKA

The transition in the outlook for fiscal policy has been drastic. As late as early December, it appeared Congress might not deliver additional support after the initial USD2 trillion relief package back in March. Now, not only have lawmakers approved a USD900 billion package, but Joe Biden's arrival in office and the Democrats' slim control of both chambers of Congress has shifted the political debate toward the new president's USD1.9 trillion proposal.

Adding further uncertainty to the outlook is the upside risk that the coronavirus vaccine could lead to a strong rebound in economic activity during the latter half of the year, officials say.

As both the rollout of the vaccine and the Biden administration's fiscal policies take more concrete shape, Fed communications will become touchier for a Treasury market where 10-year yields have already comfortably surpassed the 1% mark and talk of repeating 2013's taper tantrum heats up. Treasury curves now suggest market participants do not rule out tapering as soon as the end of this year.

"That's why the Fed will have to communicate more forcefully," said Eric Winograd, a former analyst at the New York Fed and now senior economist at AllianceBernstein.

Additionally, as spring nears, low year-ago inflation figures will begin to drop out of the 12-month calculations, resulting in a potential "inflation scare" that could further complicate Fed communications.

"It's easy to push back right now and say growth is pretty weak and the economy isn't in great shape and inflation is still below our target. So, talk to me in four months when the economy is accelerating, fiscal policy is healthy, and inflation is rising," Winograd said. "It is going to be a communication challenge for sure."

All eyes will be on how Fed officials talk about the economy and the outlook for policy, as springtime--and hopefully more widespread vaccinations--take hold. But, as things stand, the central bank is on course to continue asset purchases at its current pace.

MNI EXCLUSIVE: Fed Prepared to Stick With Vague QE Guidance (Pub Jan 15, 2021)

By Pedro Nicolaci da Costa and Jean Yung

WASHINGTON (MNI) - The Federal Reserve's vague guidance on tapering asset purchases risks creating unwanted spikes in borrowing costs, but policy makers may be too far apart to refine it further, former officials told MNI.

Investors are calling for more specificity about what policymakers mean by "substantial further progress" in the economy, their criteria for gauging an eventual reduction of the Fed's USD120 billion a month of bond buys. Officials have further muddied the waters in recent weeks by taking divergent views on the timing of such progress.

Some regional Fed bank presidents have talked about tapering by early next year while Fed governors are pushing back on any perceived certainty on timing. President-elect Joe Biden's push for major new fiscal relief through a Senate that will still have 50 Republican votes further raises the specter of market confusion, and thus requires monetary officials to lay down more concrete markers.

"It is important that the Fed clarify their balance-sheet and interest-rate reaction functions," said Stephen Cecchetti, a former New York Fed executive vice president and research director now at Brandeis International Business School. "People need to understand what the triggers will be for policy to change."

--FISCAL CURVE BALL

When the Fed delivered its December QE guidance, the chances of more fiscal relief still looked slim. Fed officials spent much of last year pleading with Congress to do more to support the economy, arguing monetary policy could not carry the rebound from a pandemic.

Since then, not only has Congress approved a USD900 billion package, but President-elect Joe Biden on Thursday night proposed USD1.9 trillion of additional relief.

The Fed is watching cautiously as 10-year yields keep rising above 1% to see whether the increase reflects optimism about growth -- or worries about premature central bank tightening in the face of rising bond issuance.

The Fed's December guidance was probably necessarily vague because of the internal disagreement on the likely path of monetary policy, sources said.

"They can't signal in advance with great precision what will be the criteria for making a change," Dennis Lockhart, ex-president of the Atlanta Fed, told MNI. "To me it's just in the nature of things that a certain degree of vagueness has to accompany the communication."

--HIGH EMPLOYMENT BAR

Fed guidance on interest-rate hikes is more specific than for QE, aimed at affirming the commitment to making up for below-target inflation that prevailed during the last recovery and ensuring full employment.

"It's a pretty high bar in terms of substantial improvement in the employment picture, which suggests to me they'll be very patient about the stance of policy," Lockhart said. The Fed's own forecasts see the jobless rate falling from the current 6.7% down to 5% this year. Fed Chair Jerome Powell said Thursday policy makers are going to be careful about communicating to markets "well in advance" before starting to reduce the pace of its bond buys.

"We know we need to be very careful about communicating about asset purchases," Powell said, adding that the "taper tantrum" experience of 2013 showed a "real sensitivity" for markets.

--EMPHASIZING THE DISTANCE

Powell's comments show the Fed "is already being tested and the leadership has already tried to respond by emphasizing distance to goals," said Krishna Guha, a former executive vice president at the New York Fed. Guha pointed to similarly dovish comments from Vice Chair Richard Clarida and Fed Governor Lael Brainard, which highlighted the divide with regional Fed hawkishness. "Expect more of the same if the market presses further," Guha said.

MNI INTERVIEW: Chicago Fed Economist Sees Low Inflation Decade (Pub Jan 12, 2021)

By Pedro Nicolaci da Costa

WASHINGTON (MNI) - A depressed U.S. labor market that keeps millions of workers underemployed will likely keep a lid on inflation for years to come, Federal Reserve Bank of Chicago senior economist Leonardo Melosi told MNI, a signal that the Fed remains focused on the threat of sluggish prices rather than a potential surge in inflation.

"This is going to be a decade in which wages and inflationary pressures are likely to be moderate," he said in an interview, citing his new research on job market slack that seeks to resolve the low-inflation puzzle that stumped policymakers during the last economic recovery.

Melosi's comments run counter to growing fears on Wall Street that a combination of strong monetary and fiscal responses to the pandemic-induced economic slump may actually generate a long-elusive burst of inflation.

The Fed's preferred measure of inflation, the personal consumption expenditures price index, rose just 1.1% in November, and recent deterioration in the growth outlook due to a winter resurgence in Covid cases portends further erosion. "I don't understand why markets see inflation around every corner," Melosi said.

--'BAD JOBS, LOW INFLATION'

His work focuses on underemployed workers who are not fully using their training or skills in the jobs they find, such as an engineer who was no longer able to find work after the Great Recession and ended up working in low-wage services, such as driver for a ride-sharing service.

"They find a job but it's not a job that fits their skills. And when a worker is in a bad job they have lower bargaining power," Melosi said, adding that the process is self-reinforcing: "Firms understand labor costs in the future are going to be low."

"Labor market slack is a multidimensional object -- we study this particular dimension which is the degree of labor misallocation," he said. "I don't see why this type of slack would be removed going forward."

Other researchers have found some 30% of the workforce was underemployed even before the pandemic. "I'm talking about a large chunk of workers," he said.

--MODERATE INFLATION BOOST

As for the risk that a large fiscal stimulus will generate inflation, earlier research by Melosi suggests otherwise. "The strategy results in only moderate levels of inflation by separating long-run fiscal sustainability from a short-run policy intervention," he said.

In a paper entitled "Monetary and Fiscal Policies in Times of Large Debt: Unity is Strength," Melosi studied the implications of greater coordination between fiscal and monetary policy to generate a sustainable recovery from a shock like the coronavirus pandemic.

"The coordinated strategy enhances the efficacy of the fiscal stimulus planned in response to the Covid-19 pandemic and allows the Federal Reserve to correct a prolonged period of below-target inflation," he said.

The Fed has signaled it will be willing to tolerate some overshoot of its 2% inflation target, a way to make up for past misses and maintain the credibility of the central bank's commitment. That move, along with the prospect of even more robust fiscal support now that Joe Biden's presidential win has been followed by two victories in Georgia that ensure Democratic control of the Senate, is reinforcing investors' medium-term inflation concerns.

MNI EXCLUSIVE: Fed Still Biased Toward More Bond Buying (Pub. Jan 6, 2021)

By Pedro Nicolaci da Costa

WASHINGTON (MNI) - Federal Reserve policymakers are still more likely to increase monthly bond buys in the near-term than to trim the pace of purchases, especially if the U.S. vaccine rollout remains disappointingly slow, ex-central bankers told MNI.

While the last-minute passage of a USD900 billion fiscal stimulus has taken some pressure off the central bank, leading to some speculation about a possible tapering of bond buys, policymakers continue to lean toward doing more rather than less.

"They would increase the stimulus if it were necessary to keep interest rates down," said Thomas Hoenig, ex-Kansas City Fed president, in an interview. "Whether that means buying the same amount each month or whether they have to increase that -- they'll do it."

A fractured distribution system and other logistical problems have marred the initial phase of vaccine distributions in the United States, potentially throwing a wrench into expectations that inoculations might be widespread by summer.

"That makes the vaccine issue all the more challenging and important," Hoenig said. "We're not off to an auspicious start."

The Fed in December offered fresh guidance on asset buying, saying it would keep acquiring Treasury and mortgage bonds at the current USD120 billion monthly pace until officials see "substantial further progress" toward the central bank's maximum employment and price stability goals.

--DEFINING PROGRESS

However, officials expect economic activity to weaken further, if not return to outright contraction in the first quarter, before improving again once vaccines are widely available and consumers and businesses can return to a semblance of normality. Darkening growth prospects in Europe, where the UK has gone into a shutdown much like that of last spring, also clouds the outlook.

Charles Steindel, a former New York Fed economist, says the Fed is probably going to define substantial progress fairly loosely -- meaning a longer period of at least the current rate of QE.

"Until we have more normal activity, with the labor force participation rate rising and people going back to work, the Fed is just going to keep going on all cylinders," he said. "Everything is still up in the air," he added. "They certainly will not think the fiscal package somehow means they will need to do less in the short run."

Indeed, Steindel wonders whether a slower vaccine distribution than had been anticipated might not require more fiscal action: https://marketnews.com/mni-exclusive-us-fiscal-bridge-seen-as-too-short from Congress beyond the USD900 billion agreement signed last month, which included direct payments to individuals and support for small businesses.

"Given the road of slowness of how the vaccine is being rolled out, we may need another stimulus package in the spring," he said.

A Democratic sweep in two Georgia runoff Senate races would make any such efforts easier, he said. As of 6:30 am, ET, one race had been widely called for the Democrats while the party held another lead in the other with 95% of votes counted. Even such a victory, however, would not guarantee more fiscal help for consumers and businesses. "I would be surprised if we get substantially more fiscal stimulus, even if the Democrats win both seats in Georgia," said Douglas Elmendorf, a former senior Treasury official and Federal Reserve economist, because moving legislation through Congress requires 60 Senate votes, not a simple majority.

That leaves the central bank's easy monetary stance as still a key, if no longer the only, game in town.

"The Federal Reserve's modeling probably suggests that the economy still needs more stimulus, it needs more support," Elmendorf told MNI.

MNI INTERVIEW: Fed Paper Makes New Case for Standing Repo Tool (Pub. Jan 20, 2021)

By Evan Ryser

WASHINGTON (MNI) - A standing repo facility might have helped the Federal Reserve head off unexpected money market turbulence as it shrank its balance sheet going into 2019, the authors of a new Kansas City Fed paper told MNI, renewing arguments for adding such a tool down the line.

A. Lee Smith of the Kansas City Fed and Victor J. Valcarcel of the University of Texas at Dallas said in an interview Friday that the drain on market liquidity as the Fed unwound its post-financial crisis balance sheet was almost twice as strong as the expansionary liquidity effects of QE, causing financial conditions to tighten and funding pressures to ripple into money markets and further to Treasury, corporate bond and foreign exchange markets.

"Quantitative tightening or normalization does not look like quantitative easing in reverse. It appears to transmit in a fundamentally different way," said Smith. While the central bank's balance sheet normalization process began in 2014, financial conditions did not begin to tighten significantly until the Fed reduced reserves in the banking system from 2017 to 2019, they found.

The lack of a tool to alleviate upward pressure on short-term interest rates as reserve balances declined effectively amplified the pass-through effect from rates to other asset markets, the authors said late last week.

--LIMITING PRESSURE

"There is no natural upper bound on rates like there is [on the lower bound] for zero, and moreover the Fed did not employ any tools, such as a repo facility," Smith said. "They did not employ that to limit upward pressure on the funds rate, so we do see a much larger degree of pass-through from reserves to short-term interest rates."

The standing repo tool, which would allow qualified dealers to exchange Treasuries for bank reserves on demand, has been a subject of discussion at the FOMC for months. Dealers and some Fed officials first raised the idea in early 2019 as the central bank was revising its monetary policy implementation framework, but a number of questions over how the tool would work in practice slowed the policy debate.

Amid the coronavirus market turmoil that forced the Fed to vastly expand the scope of its open market operations, proponents have also highlighted its potential role as an automatic market stabilizer among other proposals for money market reform: https://marketnews.com/mni-exclusive-standing-repo-facility.

--ASYMMETRICAL EFFECTS

While a repo facility could be helpful in unforeseen crises, the paper by Smith and Vacarcel show that it could also be advantageous as a guard rail at the upper end of the Fed's interest rate range -- to avoid an unwanted tightening of financial conditions when the Fed unwinds its balance sheet after the pandemic.

A core source of the asymmetries between Fed balance sheet expansion and normalization, the authors of the paper said, originates in the market for bank reserves and can largely be attributed to the central bank's toolkit for managing short-term interest rates.

"There is a much larger negative relationship between the spread in the fed funds rate and IOR and the level of reserves. That suggests that the liquidity effect is very salient during the normalization period relative to QE," Valcarcel said.

"Certainly tools you would deploy such as a standing repo facility would limit that pass-through from reserve reductions to interest rates," Smith said. "It would limit in our minds some of the tightening you would see during such an episode."

The likelihood of the Fed's adopting a standing facility depends on how fast policy makers may want to unwind financial market easing. The Fed could unwind its balance sheet while attempting to avoid tighter financial conditions, and then the case for a standing repo facility "could be made," Smith said.

MNI EXCLUSIVE: Fed Foreign Repo Boost Could Drain Reserves (Pub Dec 19, 2020)

By Evan Ryser

WASHINGTON (MNI) - The Federal Reserve could explore offering higher returns on its USD190 billion foreign repo pool next year, as it seeks ways to mitigate a surge in reserves threatening distortions in overnight rates, former Fed officials told MNI.

"It seems like it would be a consideration to take the rate up and leave it there for some time," said David Skeie, a former senior economist at the New York Fed.

Bank system reserves rocketed in March and April before settling at around USD3.1 trillion, more than double pre-pandemic levels. But with the Fed's asset purchase program to continue at a minimum of USD120 billion per month for some time and a potential Covid relief bill in Congress drawing down on the Treasury's cash balance, analysts predict reserves could push up to USD5 trillion by mid-2021.

The substantial growth in reserves could push front-end rates downward, and if unabated could cause the fed funds rate to trade in negative territory outside the central bank's target range between 0% and 0.25%, the former officials said.

--RESERVES MANAGEMENT

Tools such as raising IOER and overnight reverse repo (ON RRP) rate can put a floor under benchmark rates, and the Fed could adjust the ON RRP facility to reduce the quantity of reserves held by the banking system to relieve pressure on bank balance sheets, New York Fed's market chief Lorie Logan said in a speech this month.

Tweaking the foreign repo pool, where about 250 central banks and other institutions can invest cash with the New York Fed at a rate near ON RRP and receive securities held in the Fed's securities portfolio, "would definitely be in the mix" of other tools considered, said Steven Friedman, a former vice president at the New York Fed. The ON RRP rate is currently set at zero.

By tweaking secondary rates such as this one, "The Fed is flagging the possibility that it might consider taking steps to remove reserves temporarily from the system," said Friedman, who is now senior macroeconomist at MacKay Shields.

Adjusting rates at the foreign repo pool would boost the Fed's liabilities and offset several hundreds of billions in reserves, the former officials said.

Usage of the foreign repo pool has dipped to roughly USD190 billion from a 2020 peak of USD287 billion in April as some foreign central banks sharply reduced their overnight deposits, preferring slightly higher prevailing money-market rates. But the bulk of the cash parked at the New York Fed is from Japan which has remained steady for some time at roughly USD130 billion.