December 16, 2021

Final FOMC of the year focuses on fighting inflation

Around Thanksgiving, a Wall Street blogging site started selling Christmas sweaters with the slogan “Inflation is Transitory, Happy Holidays from the Federal Reserve”. Those who purchased the jumper now have a stranded asset on their hands as the message is very much out-of-date, demonstrating how quickly the Fed’s hawkish pivot came about.

For months, the Fed clung to the notion that pandemic-induced price pressures would come down on their own accord. This was repeatedly challenged by markets and dissident voices were emerging even from within the Fed itself. Atlanta Fed president Raphael Bostic admitted in October that he had swear jar in his office – rather than being associated with curse words, staffers (and Bostic himself) were to put a dollar in every time they used the word "transitory." Through fall, red-hot inflation showed no signs of cooling; after 5 months at 5% or above, headline CPI came in at 6.2% in October, before hitting a 39-year high of 6.8% in November. With inflation broadening out and wages rising at their fastest pace “in many years”, pressure mounted on the Fed to get a handle on prices. At his testimony before Congress on November 30th, the Chair Jerome Powell, finally dropped the word “transitory” from his inflation vocabulary. Then, at its December meeting, the Fed walked the talk and changed its policy stance from dovish to decidedly hawkish, in order to regain control of inflation and the narrative surrounding it.

Acknowledging that it’s inflation mandate had been satisfied and that the “risk of higher inflation becoming entrenched has increased”, the Fed announced that it would **double its pace of tapering from $15bn to $30bn per month**, indicating that asset purchases should draw to a close completely by mid-March.

The earlier exit from quantitative easing gives the Fed more flexibility to raise rates sooner to rein in inflation. Powell was clear that with a strong growth outlook, a rapidly improving labour market and well above target inflation, the distance between ending QE and a rate lift-off could be very short. On the labour market, the unemployment rate has plunged to 4.2%, the lowest level since the pandemic began, and Powell noted that recent improvements “have narrowed the difference in employment across groups”.

The refreshed dot plot which displays the 18 individual Fed members’ projections for interest rate hikes in the future, now shows three rate hikes in 2022. This illustrates just how concerned the Fed has become about inflation in just the last three months. In the September dot plot, half of the Fed officials believed they wouldn’t have to hike rates at all until 2023. Further out, officials now also see three more hikes in 2023 and two hikes in 2024, bringing the fed funds rate to 2.1%.

Summary of Economic Projections as of September and December 2021 (%)

		2021	2022	2023	2024	Longer run
Real GDP	Dec 21	5.5	**4.0**	2.2	2.0	1.8
	Sep 21	5.9	**3.8**	2.5	2.0	1.8
Unemployment Rate	Dec 21	4.3	3.5	3.5	3.5	4.0
	Sep 21	4.8	3.8	3.5	3.5	4.0
Core PCE	Dec 21	4.4	2.7	2.3	2.1	
	Sep 21	3.7	2.3	2.2	2.1	
Fed funds rate	Dec 21	0.1	0.9	1.6	2.1	2.5
	Sep 21	0.1	0.3	1.0	1.8	2.5

Source: Federal Reserve

Upgraded GDP and inflation forecasts for 2022 suggest that the Fed feels the economy can weather the ongoing Omicron storm and Powell commented that Americans are increasingly learning to live with each new wave of Covid.

In a nutshell, with inflation elevated and the labour market making rapid progress, the Fed is preparing for a faster drawdown in asset purchases and for tighter policy next year. While the Fed adopted a hawkish tone, equity markets reacted positively as it was perceived as being less hawkish than feared, closing down what is probably the last obstacle for market participants to prepare for Christmas and new year celebrations. The posturing also brings reassurance that the Fed is moving to curb surging inflation.

The bad news for those looking to replace their Christmas jumper is that monetary policy kicks in with a lag. In the traditional CPI basket, apparel costs were up 5% YoY in November, and, if we look at online inflation tracked by Adobe, apparel costs rose +17.3% YoY (!) over the month.

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