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INVESTMENT MANAGEMENT

A Strong Recovery in the Economy is Still Falling Short of Fed Objectives

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | April 28, 2021

Despite a strengthened economy, the Fed left interest rates unchanged at its April 28 meeting. The Fed must be patient as it evaluates the strength of the economy, understanding that sequencing matters: if the Fed starts to talk about tapering in the near future, the markets will inevitably start focusing on rate hikes, a signal that reflation policies have come to an end. In short, the Fed needs to be sure about the economy before acting.

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How does the Fed define success?

- **Dual mandate:** The Fed defines success by achieving the goals of its dual mandate of price stability (inflation) and full employment. However, Fed officials have modified the metrics for inflation and employment as they pertain to the Fed's policy reaction function.

- **Inflation:** Success is now defined as whether it is *anchored* (price stability) vs. *de-anchored*… it's no longer about keeping inflation at a 2% target.

- **Full employment:** Needs to also be viewed as a "broad and inclusive goal." It's not just a number, like the non-accelerating inflation rate of unemployment (NAIRU) or 3.9% anymore.

    - The labor force participation rate, currently at 61.5%, needs to rise to pre-pandemic levels of 63% - 63.5%.

    - Equity of outcomes from a demographic perspective, including wages

The Fed is falling short on employment objectives

- Labor/wage data is noisy due to pandemic employment benefits, but these expire in September.
- If the Fed is extra cautious, they may keep asset purchases alive until they can observe the labor market conditions post-pandemic-employment-benefits

Therefore, talk of tapering is premature

- **Fed credibility is as stake.** The Fed loudly signaled looking through strong Q2 data and remaining patient. Any discussion of tapering asset purchases before 3Q, at the earliest, would be premature and undermine the Fed's credibility.
- **When might tapering be discussed?** - The Fed's M.O. is to discuss major policy changes at the Jackson Hole Symposium in August and then make an official announcement at the September FOMC. Our best guess is the Fed follows this timeline, all else being equal. But this may be the earliest they signal tapering.
- **Tapering** may then be implemented in late 2021 or early 2022.
- **Why the delays in tapering?** Because sequencing matters. Once the Fed tapers, they implicitly signal their next move is rate hikes and then this is what the market will focus on. Rate hikes signal an end to reflation policies, so the Fed does not want to rush, and needs to see "substantial further progress in the economy" before acting.

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