Daiwa Capital Markets

U.S. FOMC Review

- FOMC: no decision on tapering, but lots of information
  : dot plot shows potential liftoff in 2022

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The Federal Open Market Committee

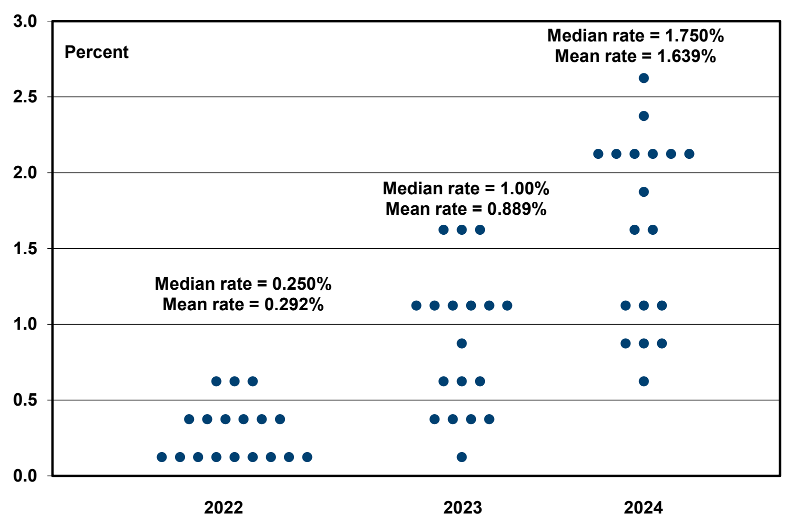
The FOMC altered its policy statement only slightly, but the shift was enough to signal that tapering of the Fed's asset purchase program was on the near-term horizon. If the economy evolves as expected, the statement noted, a reduction in asset purchases "may soon be warranted."

Chair Powell was more forthcoming in his press briefing, noting that in his mind the criteria for tapering had all but been met and that the decision could come as soon as the next FOMC meeting (November 5). The October employment report could sway the Fed's decision, but Mr. Powell noted that it would not take a "knock-out" performance to induce him to taper; reasonably good results would suffice. The statement and the Chair's comments lead us to look for an announcement in November and for the process to begin in December.

The Fed Chair also indicated that the tapering process would probably end by the middle of next year. He was asked in the briefing about possible security sales or redemptions when tapering was completed, and he simply noted that the focus at this time was on tapering; decisions on reducing the size of the portfolio would be made well down the road. We suspect that the Fed will hold an enlarged portfolio for some time. After the financial crisis, the Fed did not begin redeeming securities for three years after it ended purchases.

Perhaps more important than tapering, the dot plot shifted, with half (nine) of Fed officials now expecting to hike interest rates next year. In June, seven of 18 officials expected to hike interest rates in 2022. Because of one vacancy on the Board of Governors, currently only 18 officials participate in the meetings. The median observation, therefore, could be viewed as either the ninth dot (no change in policy) or the 10th dot (interest rate liftoff next year). In his press briefing, Chair Powell indicated that the median dot involved a federal funds rate slightly above the lower bound. We viewed that as a suggestion of a rate hike next year.

FOMC Rate View: Year-End 2022, 2023, & 2024*



** Each dot represents the expected federal funds rate of a Fed official at the ends of 2022, 2023, and 2024. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but one governorship was open at the September 2021 meeting.*

Source: Federal Open Market Committee, Summary of Economic Projections, September 2021

The FOMC made a modest (and technical and esoteric) change in policy by raising the counterparty limit on reverse repurchase agreements to $160 billion per day from $80 billion. This shift will allow for a larger drainage of reserves from the banking system, which will relieve downward pressure on short-term interest rates. This action could be viewed as supporting the notion that it is time to begin tapering. The asset purchases of the Fed add reserves to the banking system, but the Fed's counterparties have been sending the reserves back to the Fed by engaging in reverse RPs with the central bank. This change will allow even more funds to flow back. This action would not be needed if the Fed were not adding reserves through its asset purchases. Currently, the Fed is adding reserves with QE and taking them back with reverse RPs.

Economic Projections of the FOMC, September 2021*

	2021	2022	2023	2024	Longer Run
Change in Real GDP	5.9	3.8	2.5	2.0	1.8
June projection	7.0	3.3	2.4	--	1.8
Unemployment Rate	4.8	3.8	3.5	3.5	4.0
June projection	4.5	3.8	3.5	--	4.0
PCE Inflation	4.2	2.2	2.2	2.1	2.0
June projection	3.4	2.1	2.2	--	2.0
Core PCE Inflation	3.7	2.3	2.2	2.1	--
June projection	3.0	2.1	2.1	--	--
Federal Funds Rate	0.1	0.3	1.0	1.8	2.5
June projection	0.1	0.1	0.6	--	2.5

** Median projections*

Source: Federal Open Market Committee, Summary of Economic Projections, September 2021

The Summary of Economic Projections changed, now showing slower (but still firm) growth and faster inflation for 2021. The median projection of Fed officials now shows real GDP growth of 5.9 percent this year, down from an expectation of 7.0 percent in June. The shift was not surprising in light of recent economic statistics suggesting an easing from the pace of 6.5 percent in the first half of the year. Given the first half performance, the new projection implies growth of 5.3 percent in H2. Some of the easing will be made up in 2022 and 2023, as those years now show slightly faster growth. Faster than expected inflation in recent months led to an increase in the median projection for the PCE price index to 4.2 percent this year, up from 3.4 percent in June. The expected core rate moved to 3.7 percent from 3.0 percent.