First Trust
ECONOMIC RESEARCH REPORT

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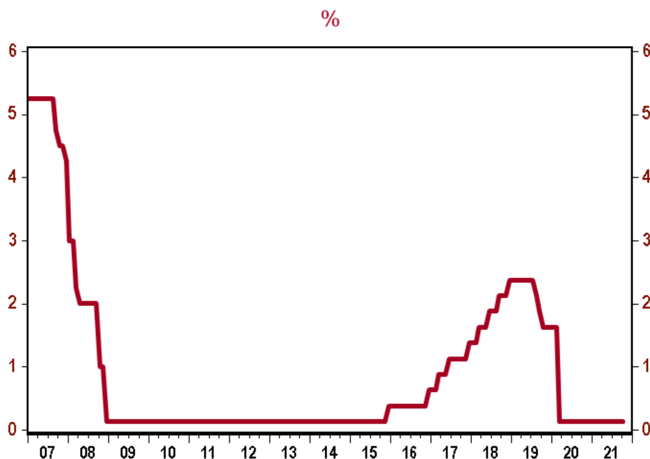
Taper Time

The Federal Reserve today announced the (much-overdue) start to tapering, which means it will continue to increase the size of its balance sheet, but not quite as fast. Starting later in November, the Fed will reduce its monthly pace of asset purchases to $105 billion per month from the current rate of $120 per month. In particular, the Fed will reduce Treasury purchases to $70 billion per month from $80 billion, while reducing mortgage-backed securities purchases to $35 billion per month from $40 billion. And the Fed expects to keep tapering Treasury securities by a further $15 billion per month (in the same proportions) starting in December. At this pace, tapering would conclude in June of 2022, just in time for the market-implied first rate hike in July of next year.

Beyond the wording changes to the Fed statement to announce the tapering timeline, there were also changes reflecting updated views on the economic front. For example, the Fed noted an additional tailwind for future activity as "an easing of supply constraints are expected to support continued gains in economic activity and employment as well as a reduction in inflation."



It's also worth noting that the Fed tempered its "transitory" inflation talk. In September, it had little doubt that the drivers of inflation would be temporary, stating the higher prices were "largely reflecting transitory factors." Today's statement hedged that comment, stating these factors are now "expected to be transitory." In other words, their confidence that inflation pressures will ease any time soon is waning.

While pushed in his press conference to comment on rate hike timing, Chair Powell was very intentional not to make any commitments, but implied that if progress meets expectations, a rate hike could likely be appropriate in the second half of next year. As per the usual line, future decisions are "data dependent," and faster or slower growth would shift that timeline. When pressed on if the Fed is starting to fall behind the curve (given that they have been consistently low on inflation expectations up to this point) and how they would react if progress exceeds expectations, Powell simply reiterated that the Fed is prepared to accelerate (or slow) purchases if the data justify it.

At the end of the day, the Fed wanted to get the process towards normalization started, but the path this will follow in the year ahead remains uncertain. There is no reason why QE should still be in effect today; tapering should have started, and ended, a long time ago. In addition, the Fed's forecast on inflation is clearly too low. And with the Fed not raising interest rates anytime soon, inflation is likely to turn out much more persistent than the Fed hopes.

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Text of the Federal Reserve's Statement:

The Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals.

With progress on vaccinations and strong policy support, indicators of economic activity and employment have continued to strengthen. The sectors most adversely affected by the pandemic have improved in recent months, but the summer's rise in COVID-19 cases has slowed their recovery. Inflation is elevated, largely reflecting factors that are expected to be transitory. Supply and demand imbalances related to the pandemic and the reopening of the economy have contributed to sizable price increases in some sectors. Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.

The path of the economy continues to depend on the course of the virus. Progress on vaccinations and an easing of supply constraints are expected to support continued gains in economic activity and employment as well as a reduction in inflation. Risks to the economic outlook remain.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With inflation having run persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent

over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved. The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. In light of the substantial further progress the economy has made toward the Committee's goals since last December, the Committee decided to begin reducing the monthly pace of its net asset purchases by $10 billion for Treasury securities and $5 billion for agency mortgage-backed securities. Beginning later this month, the Committee will increase its holdings of Treasury securities by at least $70 billion per month and of agency mortgage-backed securities by at least $35 billion per month. Beginning in December, the Committee will increase its holdings of Treasury securities by at least $60 billion per month and of agency mortgage-backed securities by at least $30 billion per month. The Committee judges that similar reductions in the pace of net asset purchases will likely be appropriate each month, but it is prepared to adjust the pace of purchases if warranted by changes in the economic outlook. The Federal Reserve's ongoing purchases and holdings of securities will continue to foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Thomas I. Barkin; Raphael W. Bostic; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Mary C. Daly; Charles L. Evans; Randal K. Quarles; and Christopher J. Waller.

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