29 October 2021

Fed Research

Preview: Tapering, yes, but how fast?

Key takeaways

- We expect the Fed will announce QE tapering at next week's meeting. We expect the Fed to start tapering immediately in November with a tapering pace of USD15bn per month (completed in June). Risk is tilted towards a higher tapering pace of USD20bn per month.
- Fed Chair Jerome Powell sounded more concerned about high inflation on Friday, which we expect him to repeat on Wednesday. We expect Powell to repeat that the tapering decision is not related to a future decision on rate hikes. Still, we expect the rhetoric to be more hawkish than in September.
- Please note that the Fed policy announcement is 19:00 CET (as the EU switches to winter time on Saturday). The press conference starts 19:30 CET.
- We still expect two rate hikes next year (one in September and one in December).
- FX: We continue to forecast EUR/USD to 1.10 in 12M (with downside risks).
- Fixed Income: We still see upside for 10Y UST yields. We currently have a 2% target.

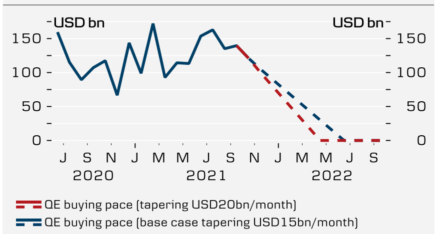
Fed call: Tapering pace is the most important factor

Friday last week, Fed Chair Jerome Powell said that he thinks it is time to taper, thus sending a strong signal that the Fed will announce tapering at the upcoming meeting next week, in line with our expectation. This also seems like consensus in markets and among other economists. **There are, however, still two things to watch out for. Will the Fed start tapering immediately already from November or wait for December? And how fast will the Fed taper?** We expect the Fed to start tapering immediately with a tapering pace of USD15bn per month, implying that the Fed ends tapering in Q2 22, in line with the illustrative path from the last meeting. Risk is tilted toward a faster, not slower, tapering pace of USD20bn per month.

It is one of the interim meetings, so there are no updated projections or dots in connection with the meeting. So all focus is on the press conference. On Friday, Fed Chair Powell sounded more concerned about bottlenecks and inflation, saying that risks are tilted clearly towards prolonged bottlenecks and higher inflation and that the Fed is monitoring inflation carefully. To us, the Fed is likely to make another hawkish shift, although it is more difficult to make a big one at interim meetings (and Powell was out speaking last Friday).

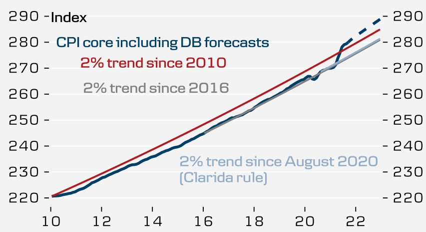
With tapering looming, the next big question is when the Fed will start hiking the Fed funds target range and how much. We recently changed our Fed call now expecting two 25bp rate hikes in September and December 2022 (see *Fed Research: Powell likely to remain chair and hike twice next year*, 14 October), as the economy should have normalised further by then with higher employment. Labour demand remains high and the labour force remains lower than before COVID-19. Also we expect CPI/PCE core to grow at a pace slightly higher than 2% annualised. Fed already says that the inflation mandate is fulfilled.

We expect a tapering pace of USD15bn per month



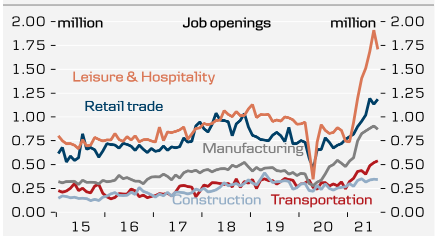
Sources: Federal Reserve, Macrobond Financial, Danske Bank illustration

CPI core is above trend – inflation mandate is fulfilled



Sources: BLS, Macrobond Financial, Danske Bank forecasts and illustration

Supply side problems? Labour demand is high



Sources: BLS, Macrobond Financial

Chief Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

Chief Analyst
Arne Lohmann Rasmussen
+45 21 46 29 51
arr@danskebank.dk

We expect, however, Fed Chair Powell will repeat that the tapering decision is not related to the rate hike decision. We do not expect markets to listen a lot to this statement. First of all it is not a new statement and investors have started to price in rate hikes anyway and second of all tapering marks the beginning of policy tightening.

The Fed is likely to remain some flexibility to increase/slow the tapering pace if needed. Also we cannot rule out that the Federal Reserve will be forced to raise rates earlier during tapering if inflation and inflation expectations rise further (or if employment growth accelerates).

Markets are pricing in an 80% probability of a rate hike in June 2022 and a total of slightly more than two rate hikes next year. So markets are slightly more aggressive than us in 2022.

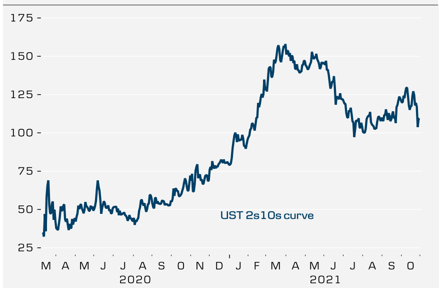
Besides that there are potentially many changes to the Fed in 2022, as President Joe Biden has a lot of important decisions to make in coming months. Not least whether to re-nominate Powell as Fed chair or not. Our base case is that Biden will re-nominate Powell despite the Fed trading scandal. We discussed in further details in *Fed Research: Powell likely to remain chair and hike twice next year*, 14 October.

Upside for 10Y UST yields

The official tapering announcement should come as no surprise to the market. Hence, the market will take its clue from the length of tapering, details regarding the composition of tapering and not least the rhetoric at the press conference. As elaborated above, we see a risk that Powell will indeed sharpen his rhetoric and in general see upside for US yields and rates over the meeting.

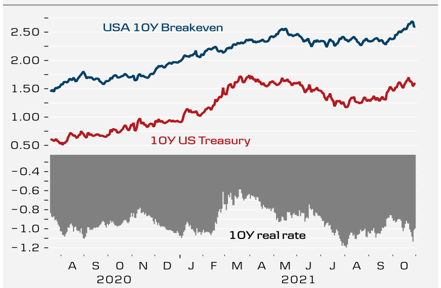
We have recently seen a pronounced flattening of the 2s10s US curve as the market has priced in a more aggressive Fed funds trajectory and as the long-end has moved lower as real rates have moved even deeper into negative territory. The latter have dragged nominal yields lower. We expect that the decision to taper over time will push longer-dated real rates higher adding upside to 10Y UST yields. In that respect, we continue to hold the view that there is upside for 10Y UST yields. We currently have a 2% target. For more see *Yield Outlook* that we published October 20.

The 2s10s US curve has flattened recently



Note: Past performance is not a reliable indicator of current or future results.
Source: Macrobond Financial, Danske Bank

10Y US real rates have moved lower



Note: Past performance is not a reliable indicator of current or future results.
Source: Macrobond Financial, Danske Bank

Our Fed call summarised

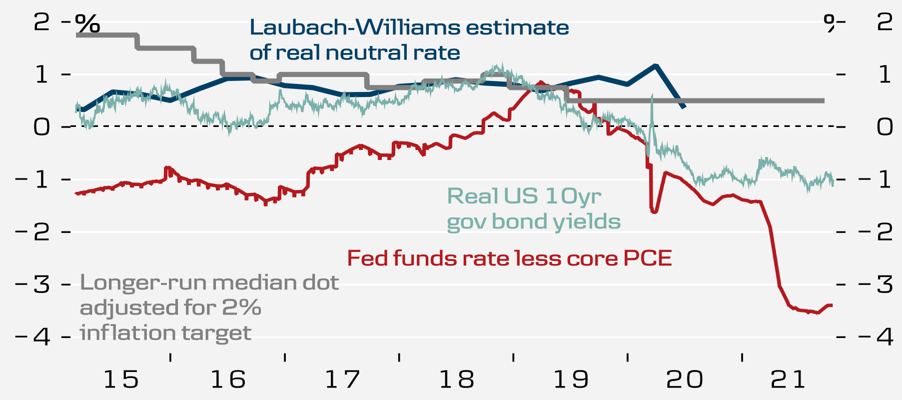
The Fed has gradually turned more hawkish in 2021 and Fed Chair Jerome Powell sounded more concerned about high inflation just recently, supporting our call that the Fed is about to start a tightening cycle including both tapering and rate hikes.

We expect the Fed to announce tapering at the upcoming meeting on Wednesday and for the Fed to reduce the monthly buying pace of USD15-20bn such that tapering is concluded in Q2 22. Our base case is a tapering pace of USD15bn per month (starting in November) with risk tilted towards USD20bn per month.

We expect the Fed to hike the Fed funds target range by 25bp both in September and December 2022 (so cumulative 50bp rate hikes in 2022), as the economy should have normalised further by then. We expect this to be the beginning of a regular hiking cycle, implying three-to-four rate hikes in 2023.

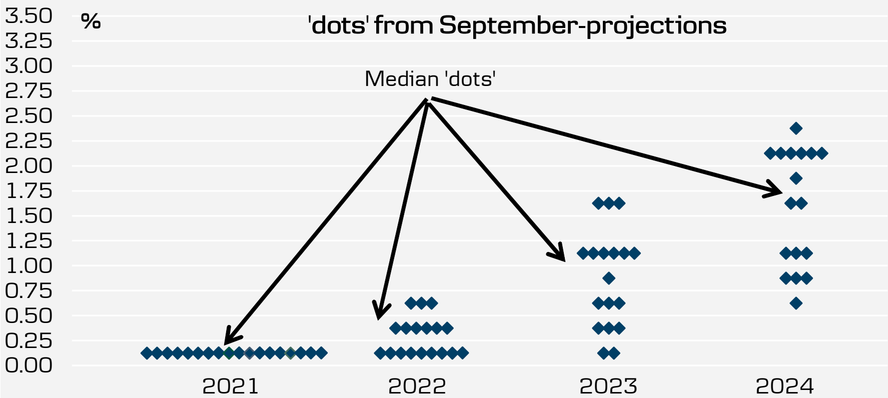
Fed charts

Monetary policy is still accommodative



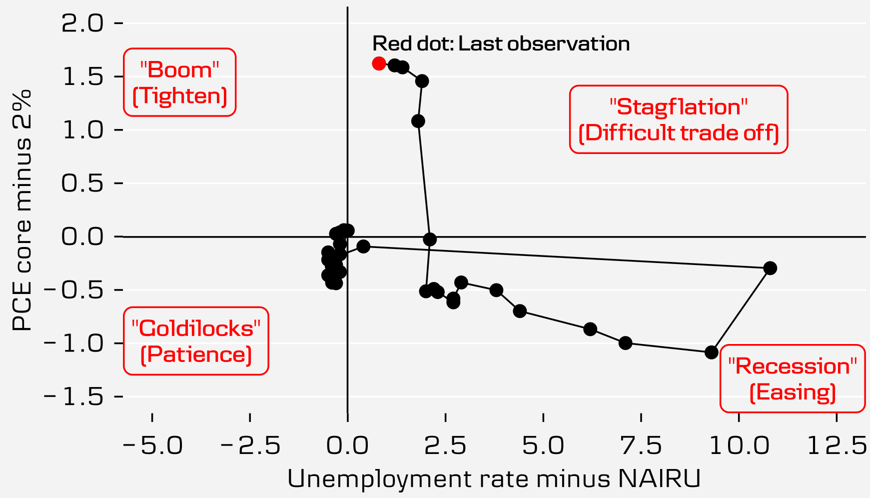
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

Fed dot plot from September



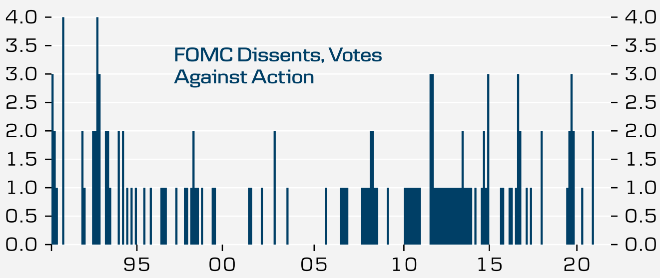
Sources: Federal Reserve, Danske Bank

Fed's trade-off



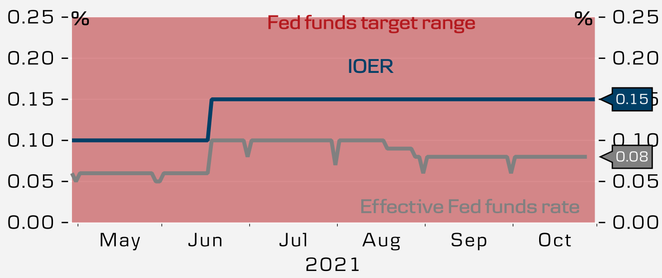
Sources: BEA, Macrobond Financial, Danske Bank illustration

The FOMC members usually work by consensus



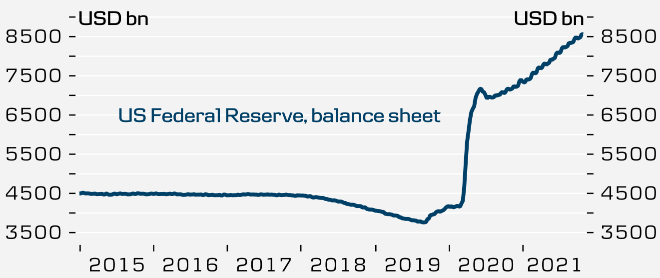
Source: St Louis Fed, Macrobond Financial, Danske Bank

Effective Fed funds rate rose after the IOER rate hike in June



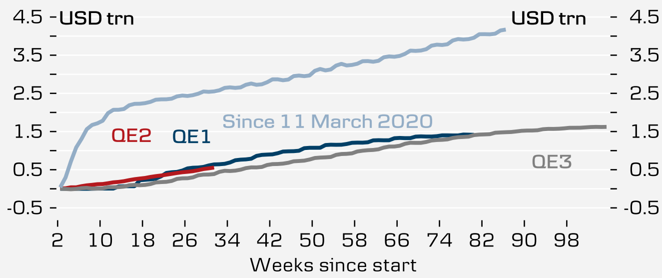
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Macrobond Financial, Danske Bank

US balance sheet has been increasing rapidly



Source: Federal Reserve, Macrobond Financial, Danske Bank

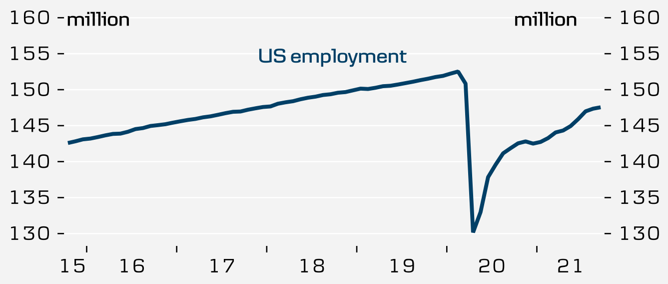
Fed is still buying USD120bn worth of bonds per month



Sources: Federal Reserve, Macrobond Financial

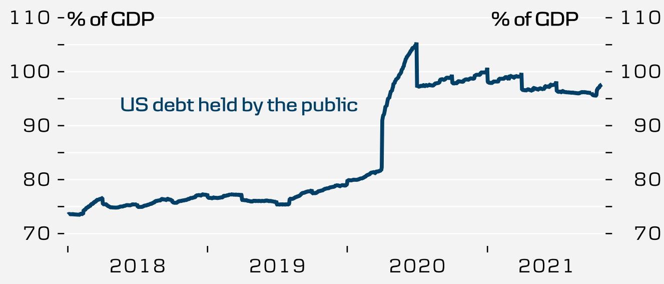
Macro charts

Employment remains significantly below pre-corona levels but jobs indicators are overall strong



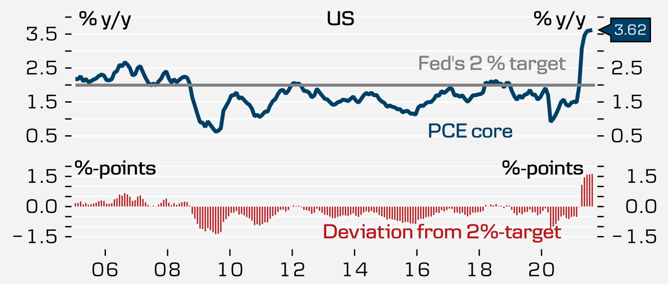
Source: BLS, Macrobond Financial, Danske Bank

US debt has been quite stable since the increase in the early days of the pandemic



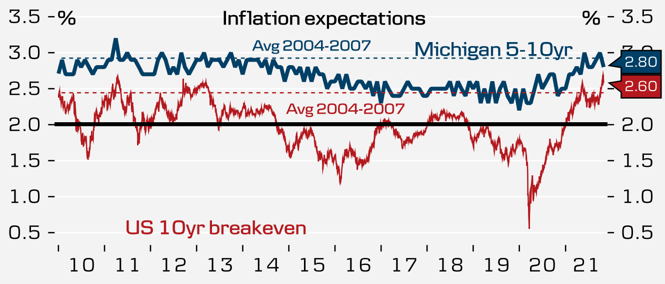
Sources: US Treasury, Federal Reserve, Macrobond Financial

Very high PCE inflation



Source: BEA, Macrobond Financial, Danske Bank

Long-term inflation expectations have risen since 2020 but remain well-anchored



Note: Past performance is not a reliable indicator of current or future results.
Source: Michigan, Bloomberg, Macrobond Financial, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Mikael Olai Milhøj, Chief Analyst, and Arne Lohmann Rasmussen, Chief Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Ad hoc.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) [('Relevant Financial Instruments').]

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank A/S is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank A/S who have prepared this research report are not registered or qualified as research analysts with the New York Stock Exchange or Financial Industry Regulatory Authority but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

Report completed: 29 October 2021, 11:16 CEST
Report first disseminated: 29 October 2021, 12:05 CEST