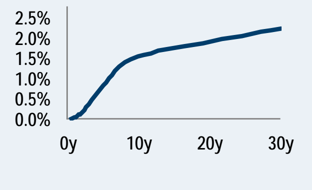
June 16, 2021

HOT INFLATION SUMMER

- The Federal Reserve held steady its target for overnight rates to a range of 0 – 0.25%, as they have for more than a year
- There were no material policy changes, and we continue to anticipate zero interest rates through 2022, possibly longer
- Bond buying to continue at the current $120 billion/month pace ($80 billion USTs/$40 billion MBS) with no sign of taper in the text
- The FOMC did increase the IOER rate in an effort to reduce some of the strains facing excess cash in banks and money market funds

Treas.	2.15PM	1.45PM	Chg.
3mo	0.03	0.01	+0.02
2yr	0.19	0.16	+0.02
5yr	0.85	0.78	+0.07
10yr	1.54	1.49	+0.05
30yr	2.20	2.17	+0.03
3m/2s	15	15	+0
2s/10s	135	133	+3
2s/30s	202	201	+1



The cool phrase for this season is the "Hot Vax Summer" (credit to John Oliver). One side effect, as we have seen from the last two months of CPI prints, is that summer 2021 is also turning into the "Hot Inflation Summer." Demand spikes in previously shuttered industries are causing prices to skyrocket, a phenomenon about which Fed officials officially don't care, at least according to the June FOMC statement. Today, the FOMC announced they were holding interest rates unchanged at their June policy meeting and further made no material changes to the accompanying statement language.

As one might intuit from our intro, the biggest development since the Fed's April FOMC meeting has been the release of inflation figures showing two months' of price spikes: +0.9% and +0.7% for the monthly core CPI in April and May, respectively. Conversely, inflation fears in both the media and markets appear to be fading a bit, as evidenced by a May 15th peak in Google search results for the word "inflation" and the decline of long run inflation expectations to about 2.40% from a mid-May peak of 2.60%. In reality, the two CPI prints represent the demand side of the inflation story without any real supply response, the latter of which will take months if not a year to emerge (just imagine how long it will take to open a new restaurant after the last year—but it will happen). In any case, financial markets seem to be buying in more confidently into the Fed's "transitory" inflation narrative, in and of itself reducing the incentive for the Fed to act in the short term to protect against higher inflation. It does not, however, stop the Fed's financial warship from turning towards reducing accommodation, a process we anticipate will take the rest of the year.

The June FOMC statement was little change for the fourth (maybe even fifth) time, with only a handful of edits. Policymakers took on the role of public health experts, declaring rather commonsensically that "progress on vaccinations has reduced the spread of COVID-19," a sort-of upgrade from caution last time around. The FOMC's assessment is that an easing public health crisis "will likely continue to reduce the effects" of the pandemic on the economy. On the inflation front, despite the aforementioned high CPI prints, the Fed left their inflation language almost completely unchanged

For the second time in as many FOMC meetings, we identified the potential for two "tinkering around the edges" policy changes: a moderate chance of a hike in the interest on excess reserves (IOER) rate to pull overnight rates further towards the middle of the Fed's target band, and an increase in the repurchase program cap. As it turns out, the Fed did this time raise IOER to 15bps and raised the rate it pays on the reverse repurchase program to 5bps. Those two measures should go a long ways to supporting bank and money market fund excess cash problems that have emerged in the last several months.

The initial market response to the FOMC statement was negative for both rates and risk assets. The combination of an IOER hike—banks in particular will demand higher yields on 2-3yr notes, now that they can earn more in overnights left at the Fed—and an increase in 2023 rate hike expectations embodied in the dots pushed yields on the front end to the belly a good bit higher. The long end of the curve outperformed slightly, in line with the normal "bear flattening" that accompanies early parts of a Fed tightening cycle. Given the subtlety of some of these changes, Powell's press conference will probably earn a bigger reaction than the FOMC statement itself.

FEDERAL RESERVE press release

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.

• Biggest single change was more optimistic language around vaccinations

Progress on vaccinations has reduced the spread of COVID-19 in the United States. Amid this progress and strong policy support, indicators of economic activity and employment have strengthened. The sectors most adversely affected by the pandemic remain weak but have shown improvement. Inflation has risen, largely reflecting transitory factors. 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 will depend significantly on the course of the virus. Progress on vaccinations will likely continue to reduce the effects of the public health crisis on the economy, but risks to the economic outlook remain.

• Inflation outlook is unchanged—was below, now above, needs to average 2%

• Bond buying continues apace, with $80bln USTs and $40bln MBS per month

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 addition, the Federal Reserve will continue to increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month until substantial further progress has been made toward the Committee's maximum employment and price stability goals. These asset purchases help 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 was again unanimous

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.

• PCE inflation for 2021 expected 3.4%, full pct above last forecast, but still looking to decline to 2.1% in 2022

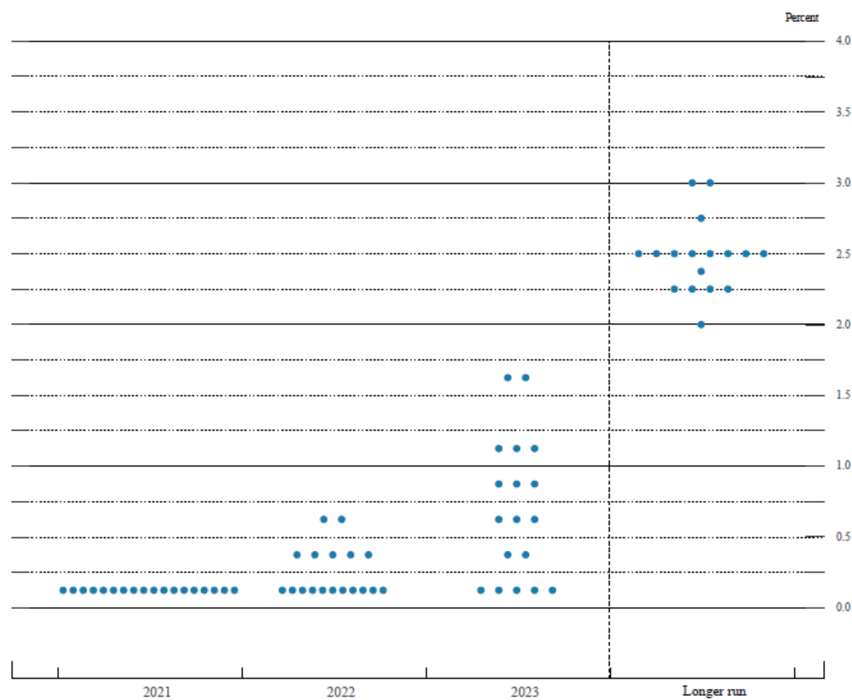
Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, June 2021

Percent

Variable	Median[1]				Central Tendency[2]				Range[3]			
	2021	2022	2023	Longer run	2021	2022	2023	Longer run	2021	2022	2023	Longer run
Change in real GDP	7.0	3.3	2.4	1.8	6.8–7.3	2.8–3.8	2.0–2.5	1.8–2.0	6.3–7.8	2.6–4.2	1.7–2.7	1.6–2.2
March projection	6.5	3.3	2.2	1.8	5.8–6.6	3.0–3.8	2.0–2.5	1.8–2.0	5.0–7.3	2.5–4.4	1.7–2.6	1.6–2.2
Unemployment rate	4.5	3.8	3.5	4.0	4.4–4.8	3.5–4.0	3.2–3.8	3.8–4.3	4.2–5.0	3.2–4.2	3.0–3.9	3.5–4.5
March projection	4.5	3.9	3.5	4.0	4.2–4.7	3.6–4.0	3.2–3.8	3.8–4.3	4.0–5.5	3.2–4.2	3.0–4.0	3.5–4.5
PCE inflation	3.4	2.1	2.2	2.0	3.1–3.5	1.9–2.3	2.0–2.2	2.0	3.0–3.9	1.6–2.5	1.9–2.3	2.0
March projection	2.4	2.0	2.1	2.0	2.2–2.4	1.8–2.1	2.0–2.2	2.0	2.1–2.6	1.8–2.3	1.9–2.3	2.0
Core PCE inflation[4]	3.0	2.1	2.1		2.9–3.1	1.9–2.3	2.0–2.2		2.7–3.3	1.7–2.5	2.0–2.3	
March projection	2.2	2.0	2.1		2.0–2.3	1.9–2.1	2.0–2.2		1.9–2.5	1.8–2.3	1.9–2.3	
Memo: Projected appropriate policy path												
Federal funds rate	0.1	0.1	0.6	2.5	0.1	0.1–0.4	0.1–1.1	2.3–2.5	0.1	0.1–0.6	0.1–1.6	2.0–3.0
March projection	0.1	0.1	0.1	2.5	0.1	0.1–0.4	0.1–0.9	2.3–2.5	0.1	0.1–0.6	0.1–1.1	2.0–3.0

• Dot plot now includes 2 rate hikes in 2023, consistent with slightly upgraded inflation forecast—but this is close to what was already priced in interest rate markets this morning

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



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