EDITORIAL

FEDERAL RESERVE: ENHANCED CREDIBILITY

More FOMC members than before are projecting a rate hike in 2022 and Jerome Powell made it clear during his press conference that tapering would happen when circumstances would justify this. Yet, 10-year Treasury yields, after an initial increase, ended up trading below the pre-FOMC meeting level. Break-even inflation also declined. Bond investors seem to share the view of the Fed that the current elevated inflation will be a transient phenomenon. This also explains the decline in the price of gold. The negative reaction of equity markets reflects an increase in the required risk premium and shows a certain unease about the impact of a less accommodative monetary policy on the growth outlook.

When bringing unpleasant news to an audience, avoid creating a surprise. That was the lesson learnt by Ben Bernanke after having stated on 22 May 2013 that *"If we see continued improvement and we have confidence that that's going to be sustained then we could in the next few meetings [...] take a step down in our pace of purchases"*, thereby triggering a jump in US treasury yields, a drop in equity markets and capital outflows hitting emerging markets.[1]

With this experience in mind, the communication of Federal Reserve officials in recent months has reiterated that any discussion about a change in policy would be flagged well in advance, in order to avoid market disruption when the decision would be announced. This had led to convoluted comments, along the lines of the FOMC members not yet having talked about when to start talking about scaling back the pace of asset purchases. In addition, forward guidance has insisted strongly on the outcome-based nature of the policy stance, with the decision dependent on the behaviour of inflation and unemployment.

Compared with Bernanke's all in all cautious (*"take a step down"*) words, the comments of Jerome Powell during the press conference following the latest FOMC meeting were surprisingly blunt: *"we will do what we can to avoid a market reaction. But ultimately, when we achieve our macroeconomic goal, we will taper as appropriate."*[2] The direction of the market reaction was as expected, but the extent was small, in particular compared to what happened after Bernanke's comments in 2013.

This time around, investors were fully aware that change in the Fed's message had become increasingly likely. 'Message' refers to the survey of economic projections of the FOMC members (SEP), commonly called 'the dots'. Since the previous SEP in March, both the US economic situation and outlook have improved significantly, so it was almost inevitable that the number of FOMC members expecting a rate hike would rise. This was confirmed by the new SEP with 7 out of 18 members projecting at least one hike in 2022 versus 4 previously (chart 1). To some degree, this slightly hawkish message reinforced the credibility of the FOMC, with seven of its members sending a signal that they will not shy away from tightening when circumstances require. This was also Powell's line during the press conference. As a consequence, the Treasury curve flattened with the rise of the 5-year yield reflecting an anticipation of the first rate hike coming earlier than expected hitherto, whereas the more limited increase in the 10-year yield – followed by a decline – suggests the market considers that the cumulative tightening won't need to be that important to bring inflation under control.

1. Fed chairman Bernanke made his comment in answering a lawmaker's question during an appearance before Congress' Joint Economic Committee. Source: Key events for the Fed in 2013: the year of the 'taper tantrum', Reuters, 2019. 'Unpleasant' is defined from a market perspective, considering that investors, on average, tend to react negatively to the prospect of a monetary tightening. It illustrates that what is good news for most people –the economy doing better- can be bad news for some.

2. Source: Federal Reserve, Transcript of Chair Powell's Press Conference, 16 June 2021.

FOMC PARTICIPANTS' ASSESSMENTS OF APPROPRIATE MONETARY POLICY: MIDPOINT OF TARGET RANGE OR TARGET LEVEL FOR THE FEDERAL FUNDS RATE

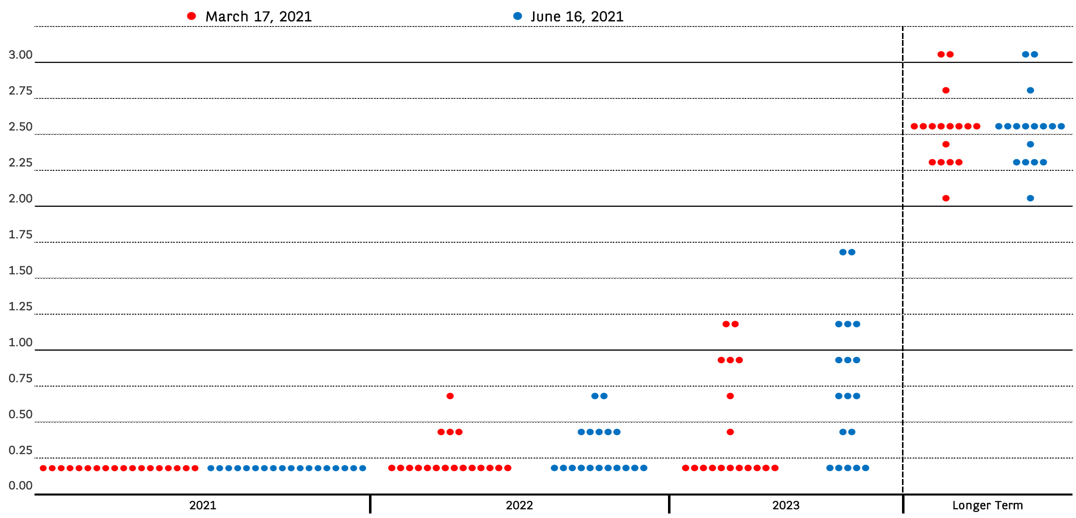

CHART 1

SOURCE: FEDERAL RESERVE, BNP PARIBAS

This is perhaps the most important conclusion from the latest FOMC meeting outcome: break-even inflation has declined, so bond investors seem to share the view of the Fed that the current elevated inflation will be a transient phenomenon and that a limited degree of tightening will be sufficient to keep inflation under control. This also explains the decline in the price of gold. Considering that 10-year yields are now trading below the pre-meeting level, the decline of equity markets reflects an increase in the required risk premium, representative of a certain unease about the impact of a less accommodative monetary policy on the growth outlook. Another striking development has been the extent of the strengthening of the dollar versus the euro. This will be welcomed by the ECB as a stronger dollar eases financial conditions in the euro area.

William De Vijlder

MARKET REACTION TO THE FOMC MEETING AND PRESS CONFERENCE

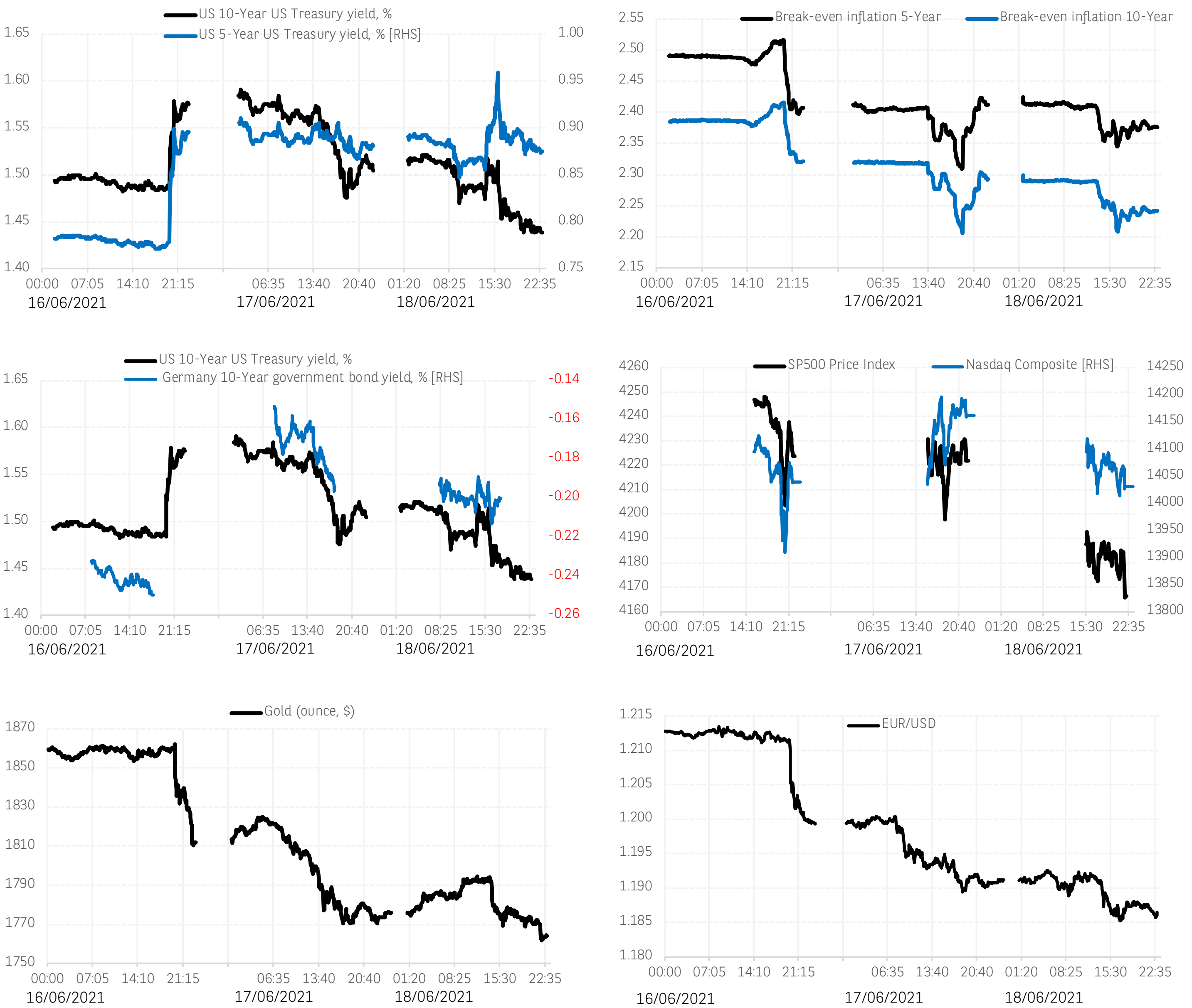

CHART 2

SOURCE: BLOOMBERG, BNP PARIBAS