UNITED STATES: TRYING TO READ THE MIND OF THE FEDERAL RESERVE

The new economic projections of the FOMC members reflect a big but temporary boost to growth from the fiscal stimulus and the normalisation of economic activity as the adult population is vaccinated. They expect a limited, temporary increase of inflation. Four participants now expect that the circumstances would warrant an increase in the federal funds rate next year. Seven expect this to be the case in 2023. Fed chairman Powell was quick to point out that the projections are not a committee forecast and that the data do not justify a change in policy. This message clearly anchors short-term interest rates, whereas longer-term bond yields fluctuate on the waves of ease or unease about where the federal funds rate could be several years into the future.

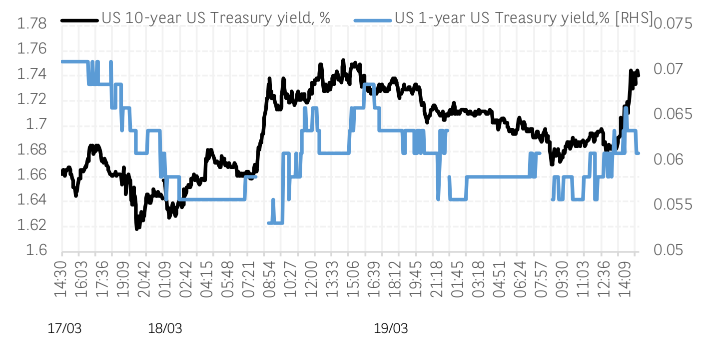
Since October 2007, the participants of the FOMC meeting - the 7 members of the Board of Governors and the 12 presidents of the Federal Reserve Banks – have submitted their individual economic projections on a quarterly basis. They are assembled in a document called "the Summary of Economic Projections". In the charts that are also published on that occasion, individual projections for the federal funds rate are shown with a dot, which is why Fed watchers tend to refer to them as 'the dots'. The latest release, published on 17 March, was eagerly awaited, considering that so much had happened since the previous one, published last December: a quick and very successful vaccination campaign, an improvement of economic data and a USD 1.9 trillion stimulus package. The median projection of the FOMC members for this year's real GDP growth has been revised upwards from 4.2% to 6.5%. More telling is the change in the range of individual projections, which has moved from 0.5-5.5% to 5.0-7.3%. Core inflation for this year is now projected at 2.2% (1.8% previously) with a range of 1.9-2.5%. Next year, it would drop to 2.0% on the back of growth slowing to 3.3%. The projections thus reflect a big but temporary boost to growth from the fiscal stimulus and the normalisation of economic activity as the adult population is vaccinated.

Unsurprisingly, considering the significant increase in Treasury yields in recent weeks, much of the focus during Jerome Powell's press conference was on the interest rate projections and what they convey about the outlook for monetary policy. Four FOMC members now expect that the circumstances would warrant an increase in the federal funds rate next year. In December only one member was of that opinion. For 2023, seven members now expect that conditions would be met to tighten policy (five in December), although 11 still consider that the policy rate could remain unchanged. The Fed chairman was quick to point out that the projections are not a committee forecast: *"It's not something we sit around and debate and discuss and approve, and say this represents, you know, our reaction function as a committee."* Whilst acknowledging that inflation should accelerate this year, due to base effects and bottlenecks, the increase should be "relatively modest" for a number of reasons. The supply side of the US economy is very dynamic –bottlenecks do not last forever-, some companies may prefer not to hike prices –to protect or increase their market share- and inflation expectations are strongly anchored around 2%.

These statements did not stop bond yields from moving higher the following day. Bond investors may be more concerned than the Federal Reserve about upside surprises to inflation because of the detrimental impact on their performance. It creates a herding type of behaviour: when you think your competitors have reduced their exposure to interest rate risk, you will be tempted to do the same if you consider that inflation could surprise to the upside. What is also in the back of the investors' mind are the clear signals by Powell of a decisiveness to act should inflation expectations become unanchored[1] or when economic conditions justify so. The outcome-based guidance depends, by construction, on the progress towards the Federal Reserve's goals in terms of inflation and employment: *"We'll tell people when we think - until we say, until we give a signal, you can assume we're not there yet. And as we approach it well in advance - well in advance - we will give a signal that yes, we're on a path to possibly achieve that, to consider tapering."*

1. *"If we saw inflation expectations moving materially above 2 percent, of course, we would conduct policy in a way that would make sure that that didn't happen. We're committed to having inflation expectations anchored at 2 percent, not materially above or below 2 percent".* Source: Federal Reserve, press conference of Jerome Powell, 17 March 2021.

US: INTRADAY INTEREST RATE



SOURCE: BLOOMBERG, BNP PARIBAS

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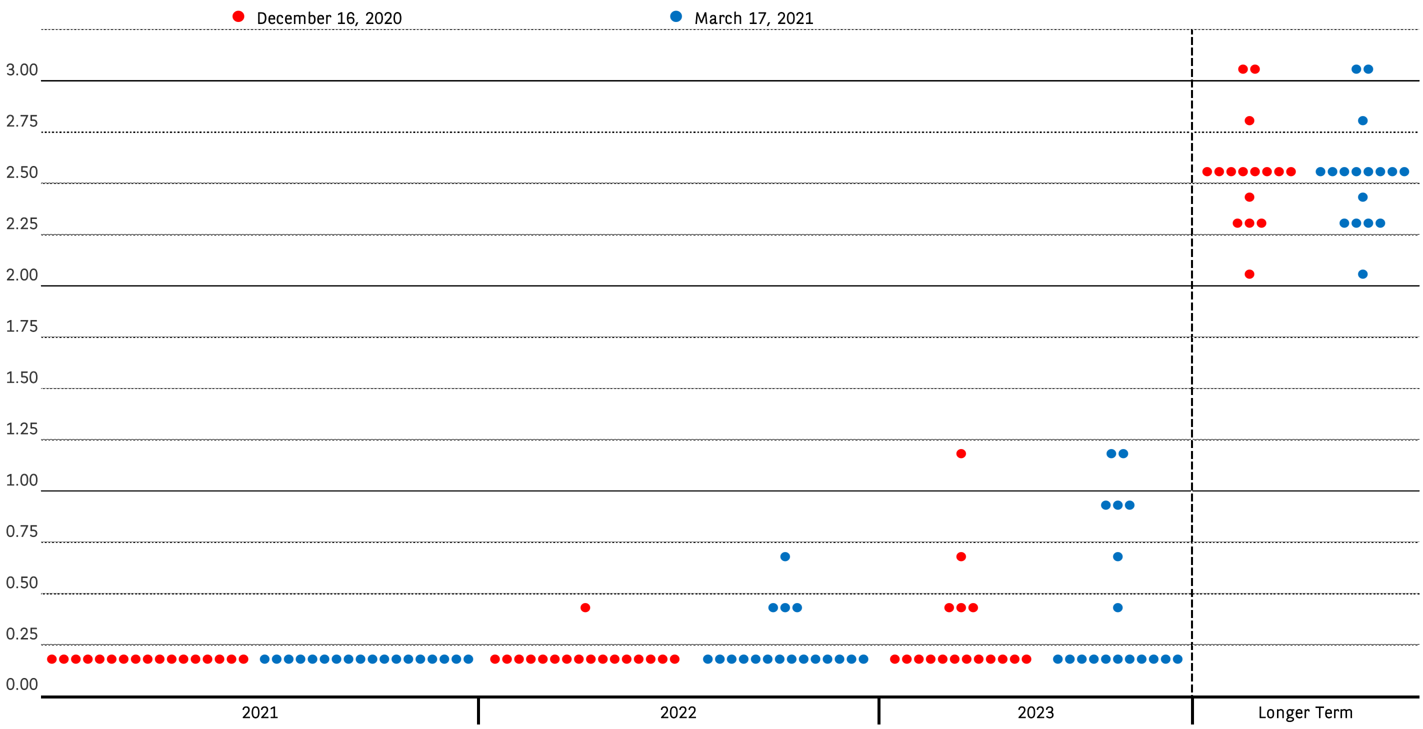
This message clearly anchors short-term interest rates, whereas longer-term bond yields fluctuate on the waves of ease or unease about where the federal funds rate could be several years into the future. To quote Nobel Prize winner Paul Krugman from a recent appearance on Bloomberg Television, *"it's a question of reading the Fed's mind"*.

William De Vijlder

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



SOURCE: FEDERAL RESERVE, BNP PARIBAS