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FOMC review: Tapering is all about the delta on delta

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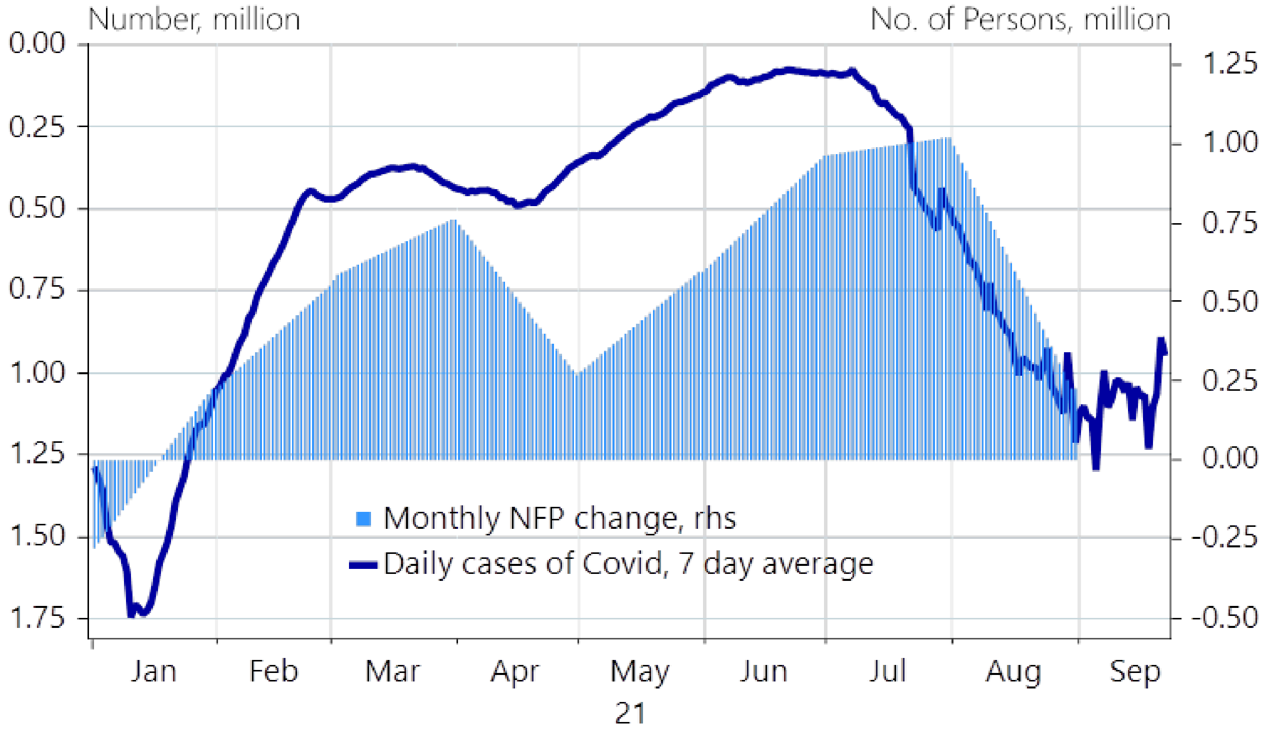
The FOMC is very close to admitting to “substantial further progress” on both mandates (inflation and employment), which means that tapering will be started in November unless something unexpected happens. USD remains a good pick!

The growth prospects were lowered, while inflation prospects were hiked by the FOMC and the dot plot / rate path was split 50/50 between a hike or no hike in 2022 – in any case ahead of expectations. If the Fed sees that the economy continues to expand according to expectations, then they could easily move ahead the next meeting and Powell even sees conditions met for starting to taper himself. **November is now the base case for tapering.**

Powell hinted that 755K as the three-month average of the NFP job creation remained solid, which is fully in line with our view that a 600-800k on average over three months is easily enough to convince the Fed of moving on tapering already in November. **The pace of tapering will likely be calibrated towards ending the net purchase by summer 2022** – again in line with our expectations since the early spring. This is much swifter than the 2014 tapering process if succeeded, since the 2014 process took around 10-12 months from a lower initial nominal monthly purchase level.

The Covid-19 development is now the focal point for tapering. If the next job report is solid (300-500k), it seems as if the Fed is ready to move as they are close to admitting to “further substantial progress” on both goals. They already accept that inflation has “more than proceeded substantial further progress” but they are also very close to accepting it on employment. The Delta development was the “culprit” behind a weaker August job report and judging from the most recent virus developments we would argue that the September report will already be (considerably) stronger. The delta on delta is ALL that matters now.

Chart 1. Delta vs. NFP – Covid is THE driver of NFP



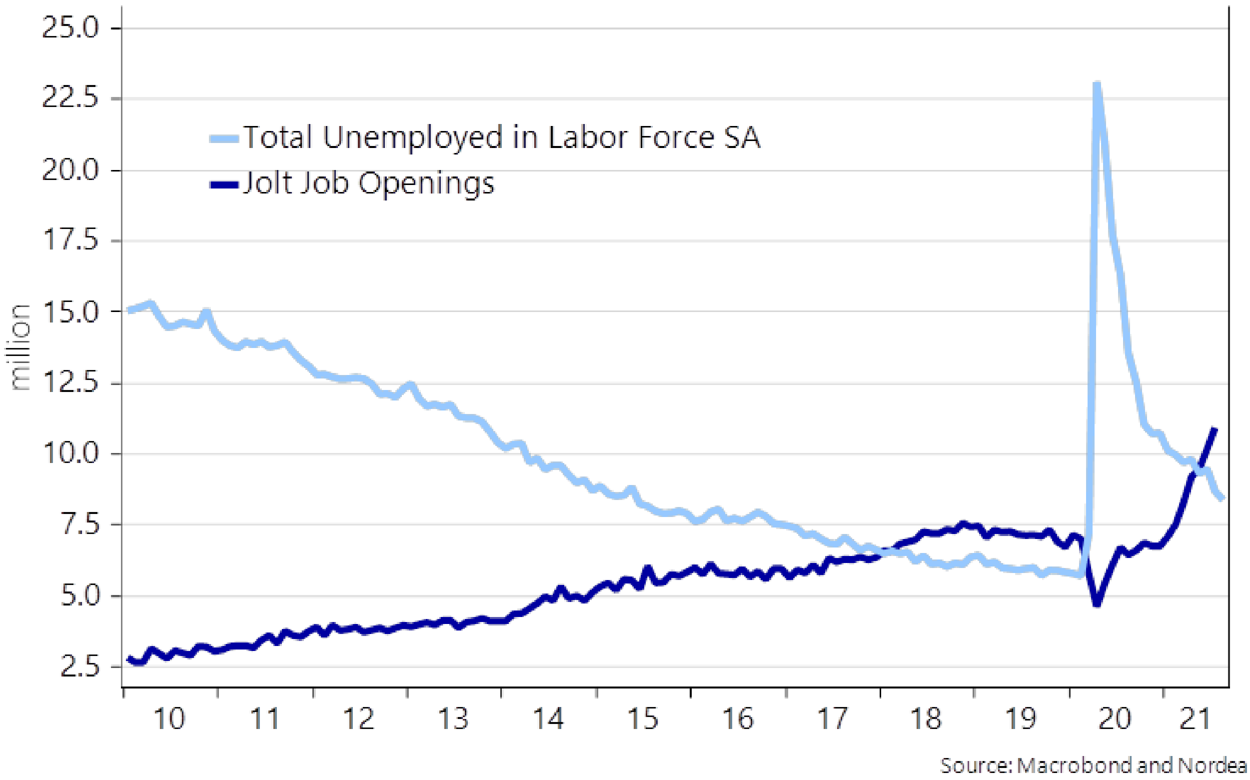
Source: Nordea and Macrobond

Jay Powell remains firm that the tapering process is fully disconnected from the actual lift-off timing, why the market probably shouldn't take too much notice of the new dot plot, which hints of a 50/50 division within the FOMC on a 2022 lift-off. We see a clear risk that the Fed is further behind the curve than usual since that the AIT-regime has allowed them to respond later to progress on inflation and partly in the labour market.

The job opening bullishness remains historically elevated in the US with above 11 million job openings, which is more than the registered unemployment. A very bullish signal for wage growth if labour supply is not coming back in size very soon. This is a reason to expect the Fed to turn bullish AHEAD of expectations since the employment will either turn super-hot or else wage growth will have to rally swiftly due to a lack of supply.

We expect a 40bn a quarter tapering process commencing in November (with initial focus on MBS purchases) and a first lift-off in the late autumn of 2022. Do note that Powell referred to a lift-off being possible "earlier than assumed", which in our view is consistent with a H2-2022 lift-off target even despite Evergrande and all that. Voting-wise Bullard, George, Mester and Rosengren are back in 2022, while Evans, Daly, Barkin and Bostic are out. **A clear hawkish tilt.**

Chart 2. The labour market demand vs. supply ratio still looks extremely bullish

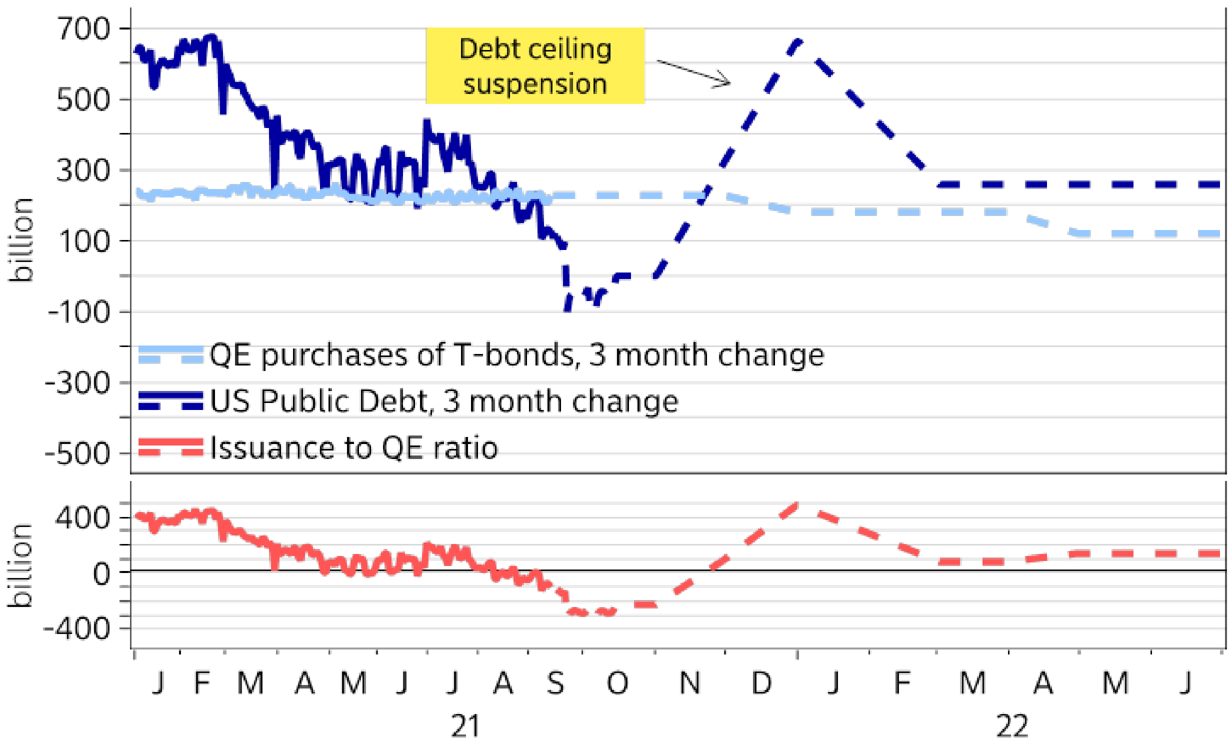


The still unsolved issue on the debt ceiling is still important for US fiscal (and monetary) policy. A worst-case postponement of a debt ceiling solution until around 1st of November currently seems unlikely, but the newer x-over date suggests that the ultimate political deadline is already in play during the middle of October. T-bills price in a risk around the middle of the month, while revenue data has surprised negatively since the most recent update on the x-over date from the Bipartisan Policy Center.

This could leave a potential double whammy upcoming in the late fall, if the overall issuance of T-bonds is allowed to resume from late October, while the Fed intends to start tapering only a few weeks later (3rd of November). This will leave the Treasury market in a Q1-2021 supply situation with at least $500bn of net issuance adjusted for QE on a net 3 month basis having to be swallowed by private investors. **This leaves a clear risk of a stronger USD, higher USD bond yields and a more expensive USD in the xCcy basis in to year end as the clearly most likely scenario. The Fed is not as dovish as you think.**

Nordea

Chart 3. Debt issuance to QE will rise to new high levels during Q4



Source: Macrobond and Nordea

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