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Daily Observations

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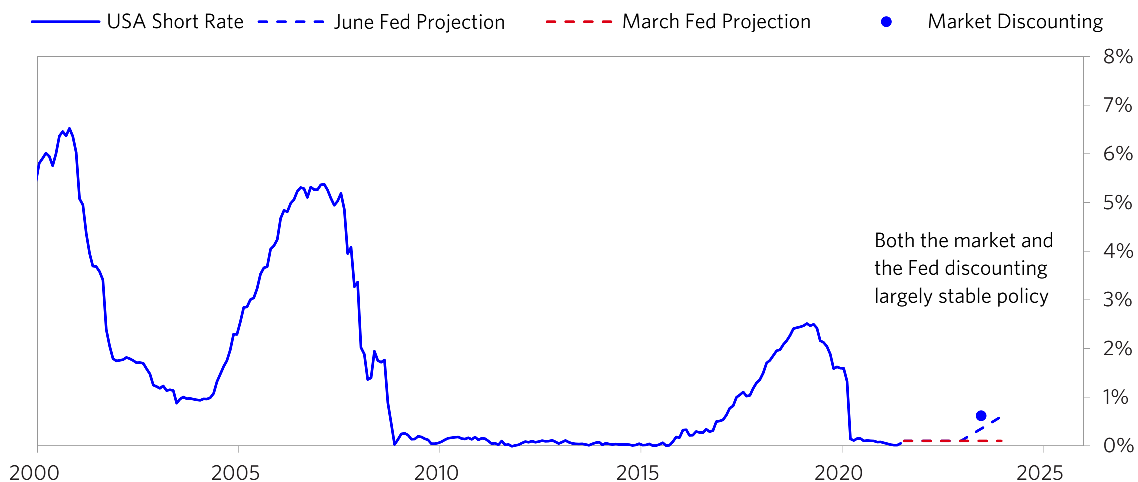
US Economic Circumstances Have Dramatically Changed in the Last Year; the Fed Is Beginning to React

The Fed will ultimately respond to conditions as they unfold and not to what they think those will be.

The Fed's reaction function has evolved in recent years to deal with the asymmetric risks posed by near-zero interest rates and secularly weak inflation. But this shift won't stop the Fed from responding to conditions as they unfold. Wednesday's monetary policy meeting demonstrated a clear recognition that the aggressive monetary and fiscal policies of the last year are working and may need to evolve. However, given the Fed's shift, policy going forward will be determined more so than ever by the actual conditions the Fed faces, not their outlook. As we see it, the second half of 2021 is setting up to be one of the strongest and broadest cyclical expansions in decades, and material risks of a sustained pickup in inflation are also becoming hard to ignore. Relative to these conditions, both the Fed's prior outlook and the current pricing of highly negative real short-term rates and stable inflation for years to come look unrealistic to us. Wednesday's market action was consistent with only a few basis points of additional Fed tightening and with the fact that the Fed is still only talking about thinking about tightening.



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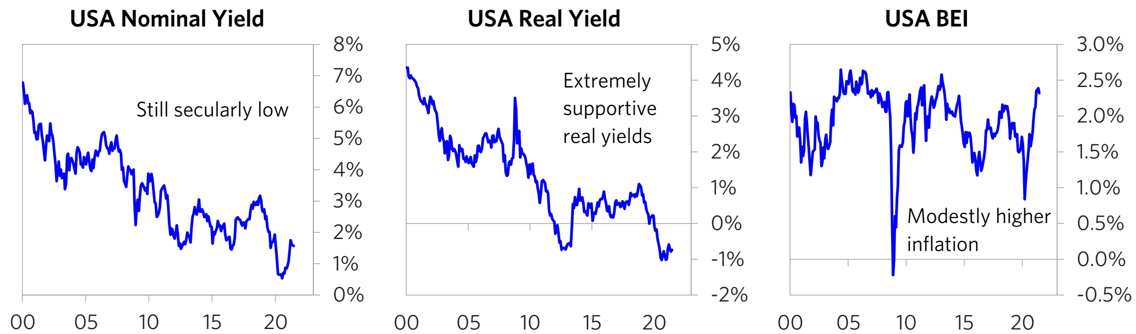
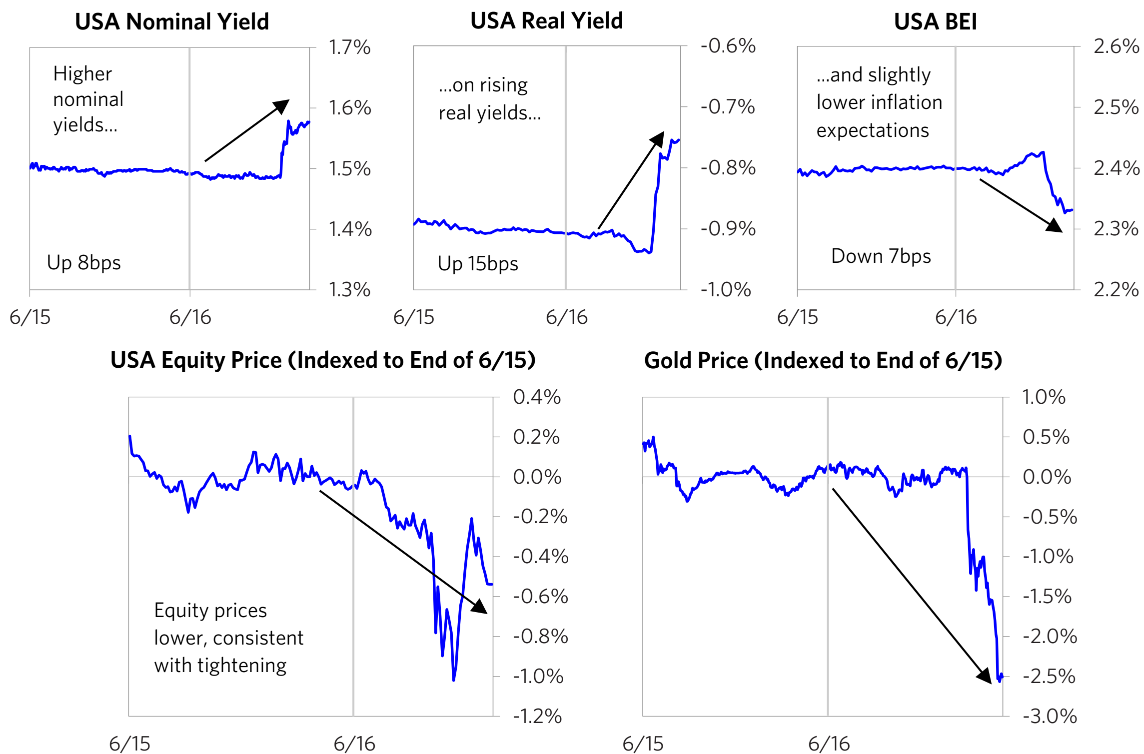
The Bond Market Is Pricing That It Will Take a Decade of Negative Rates to Achieve the Fed's Target

Nominal bond yield levels are up ~100bps from lows but are still only at pre-COVID historical lows. The makeup of this pricing reflects an extrapolation of extremely easy monetary policy over the next decade. Long-term real interest rates are just north of -1%, while discounted long-term inflation expectations are near the Fed's target and a bit higher than they were pre-COVID. Given the cyclical strength of the economy, the healing of balance sheets, and the upward pressures on inflation, we see this configuration as unlikely. The nominal pricing is being supported by large ongoing bond purchases and perhaps by the Fed's guidance as well. If the Fed remains as easy as is priced in, the odds of a more sustained rise in inflation are higher than what is discounted. As we show further below, Wednesday's market action only changed the pricing slightly.

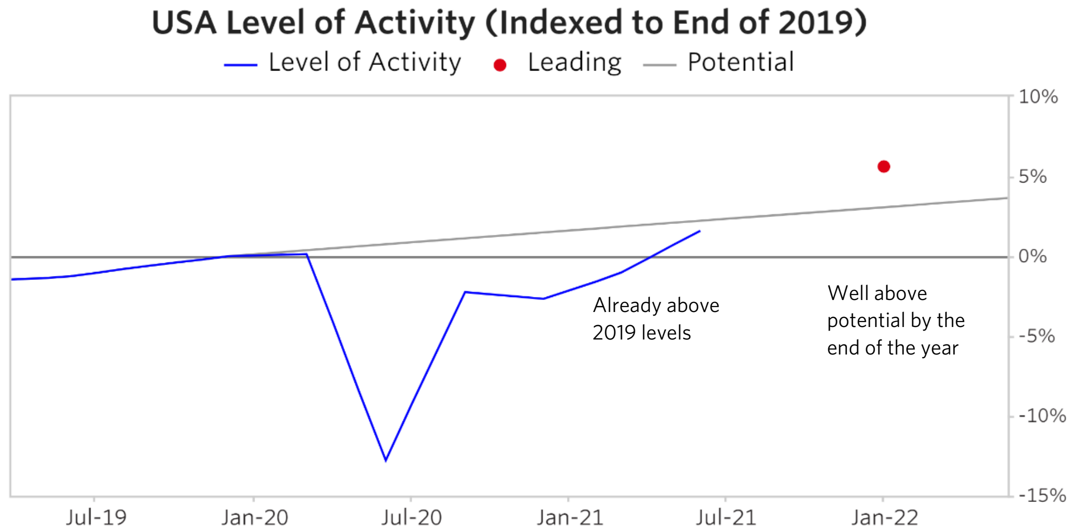


As you can see below, Wednesday's market action was consistent with a moderate tightening. Bond yields rose around 8bps, reflecting an increase in real yields that was only partially offset by falling inflation expectations. Equities fell, consistent with higher bond yields and less stimulation. Lower inflation expectations can be seen in both the breakeven inflation rate and in falling gold prices. The dollar also rose modestly.

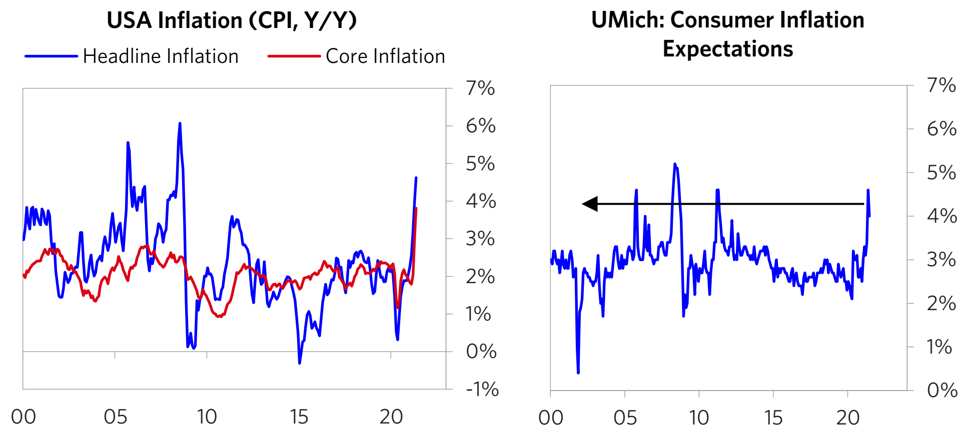


Growth Surge Likely to Continue Quickly Absorbing Slack in the Economy

As we have described in prior *Observations*, the US is currently experiencing a warp speed recovery, which we expect to bring about late business cycle conditions very quickly. Levels of activity have already recovered to above where they were in 2019, and conditions are extremely supportive on all fronts (e.g., stimulation, reopening, strong cyclical backdrop). Between March—when the Fed last published their projections—and today, our measures have levels of activity rising almost 2%.



By our measures, pressures on inflation are at highs, driven by unprecedented demand hitting relatively tight capacity and a historically accommodative monetary policy. Below, we show core and headline CPI. While there are clearly one-off drivers of inflation at play (e.g., supply chains adjusting, reopening), the gains in inflation have been broad-based across categories. Inflation expectations have also risen meaningfully, and expectations of inflation becoming entrenched increase the likelihood of inflation becoming sticky.



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