Powell: provides a 'dovish' tapering hint

- At the Jackson Hole Symposium, the Federal Reserve Chairman indicated that tapering could commence by the end of 2021, but provided a relatively dovish guidance
- First, he continued to emphasise that 'tapering' will not automatically imply that the Central Bank will commence a policy rate hiking cycle. He said that the yardstick used for tapering will be different than that used for policy rate hikes
- He also emphasised that even with a possible move towards tapering, the size of the balance sheet will imply that financial conditions remains accommodative
- While he did express concerns about the current inflation rate and said that the FOMC has met its inflation mandate, he maintained his view that the rise will be 'temporary' and will have to be 'monitored' carefully
- On the labour market, he acknowledged that progress has been made. However, the emphasis was that 'slack' still remains in place
- We maintain our view that the FOMC will commence tapering by December-2021. There also appears to be growing divergence within the FOMC as Powell's speech stands in contrast to other regional FOMC Presidents who have been calling for an immediate move towards tapering, as early as October
- For the market, the assertion that policy rate hikes will not be tinkered with, tapering does not equate to tightening and that policy will remain accommodative will likely keep the US yields and the USD restrained, in the near-term. However, we retain our medium-term bullish view on the USD and expectations that the US yields are likely to trend higher.

A dovish tone, with some indications that tapering is on the cards: The much anticipated Jackson Hole address on the 'economic outlook' from Mr. Powell provided strong signals that 'tapering' is on the cards that could commence by the end of the year. However, several references were made to the fact that the Central Bank will continue to be cautious in examining incoming developments on the economy. **Emphasis was also placed on explaining that the normalisation process is likely to remain gradual as the economy evolves in line with expectations.**

For one, the Fed Chair continued to de-link tapering from tightening by stating that "I was of the view, as were most participants, that if the economy evolved broadly as anticipated, it could be appropriate to start reducing the pace of asset purchases this year." These statements were, however, qualified by stating that "the timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of the interest rate lift-off, for which we have articulated a different and substantially more stringent test." He further added, even with tapering the size of the balance sheet should remain sizeable, ensuring that the monetary policy remains accommodative.

Recovery from the recession- some thoughts: The FOMC Chair started his speech by stating that the recovery from the recession has been spectacular, but uneven in nature, supported by the policy environment. Incomes have risen that has resulted in a surge in output and consumption, led by an increase in durable goods. However, consumption on services is still catching up slowly and remains 7% below the base-line pre-pandemic levels. The labour market improvement has been sizeable, but is still lagging the increase seen in the output.

Maximum employment mandate - Getting there: He continued to acknowledge that the labour market has improved considerably, but stated that the level of *'unemployment remains fairly high at 5.4%'*. His message was that considerable slack remains in place. However, he provided a constructive outlook by stating that *"while the Delta variant presents a near-term risk, the prospects are good for continued progress towards maximum employment"* that was qualified by stating that "*We have much ground to cover to reach maximum employment."*

Inflation overshoot is being viewed as 'temporary', but mandate has been met: He yet again stated that *"inflation has reached 2 percent and is on track to moderately exceed 2 percent for some time"* in line with the Fed's mandate. He expressed concerns about the elevated level of inflation, but stated that the forces could remain temporary in nature. He talked about the sources of temporary inflation pressures. He yet again emphasised that the current spike is being driven by a narrow basket of goods and services that were most affected by the pandemic. Most of these increases were showing signs of softening. **In explaining the cautious manner in which the Central Bank will examine the inflation trends, he drew parallels to very different episodes in the US history—1950s and the 1980s.** In the 1950s, inflation was driven by temporary factors that policymakers responded to by tightening the policy that subsequently weighed in on the economic activity with a lag, resulting in the slack in labour market and lower output.

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In the 1970s' large one-off increases were seen in energy and food inflation, but that did not invoke any substantial monetary response. However, as the direct impact on the headline inflation eased, core inflation remained persistently higher as 'inflation expectations' had structurally been lifted.

He also stated that the FOMC will monitor a broad array of inflation indicators—including wage price trends that were expressed as rising, inflation expectations, drivers of PCE inflation and global factors. He, however, pointed out that the global disinflationary forces could remain firmly in place. In short, the FOMC will monitor whether 'inflation' is temporary or 'persistent' as he stated that *"time will tell whether we have reached 2 percent inflation on a sustainable basis."* We maintain our in-house view of inflation turning out more persistent than temporary.

Outlook: ***Although concerns about the Delta variant were expressed, Mr. Powell has laid the groundwork for a QE taper announcement. We think that further indications of a move towards tapering could come in the September policy meeting followed by a commencement in December of USD 15 billion, per month. QE could end by Q32022 that will be followed by rate hikes possibly in Q42022 or Q12023, once there is more clarity on the 'persistent' nature of inflation.***

For the markets: it was a dovish outcome: **In the near-term, the explicit guidance of the FOMC taking a cautious view on the normalisation of the monetary policy. Besides, the emphasis of decoupling of 'tapering' from 'tightening' could support the risk sentiment putting some downside pressure on the DXY and US longer-end yields.** However, we maintain our DXY range of 91.50-93.50 for Q32021 and the UST 10-year yield range of 1.15%-1.40% range for Q32021. However, we see more near-term downside potential relative to our base-line scenario in the USD/EM pack as 'carry' and 'risk seeking returns.

Going in to Q42021, we see more upside potential in the US yields and USDs performance against both DMs and EMs. We see the DXY moving to the 94.00-95.00 range and the UST 10-year yield at the 1.5%-1.8% range by end-2021-Q12022, as the FOMC's guidance will likely have to gradually shift to becoming more hawkish to prepare for rate hikes later in 2022 or early 2023.

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