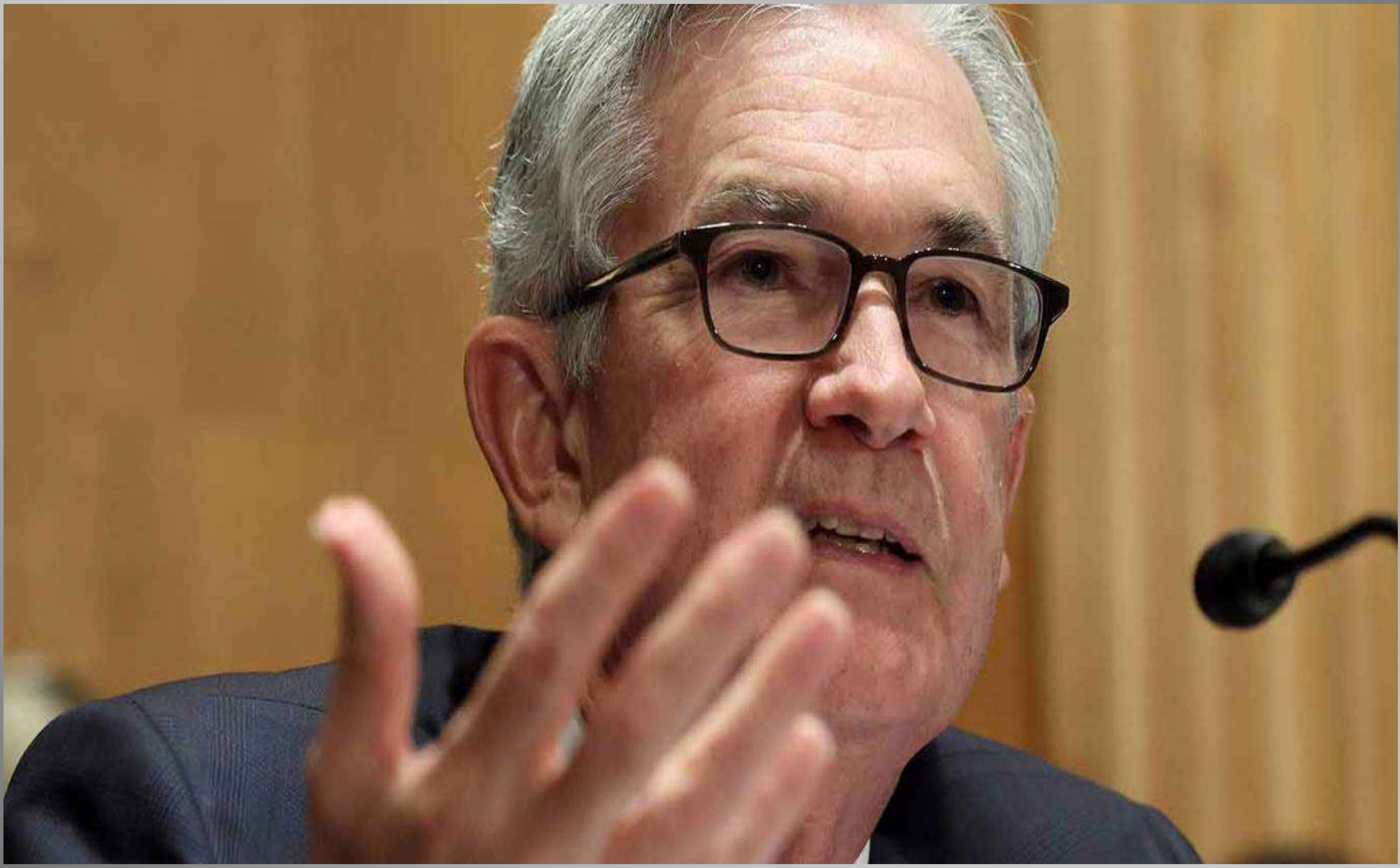
# US Monetary Policy

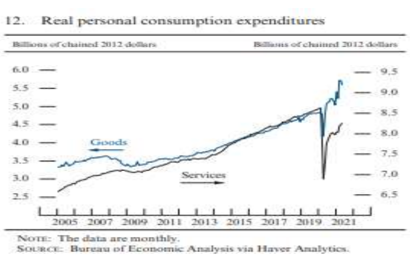


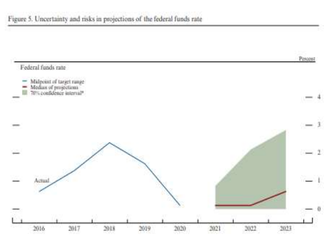
## Prevailing Economic Scenario

In the Jackson Hole Economic Policy Symposium held on Friday, United States Federal Reserve Chairman Jerome Powell concluded his speech on a positive-note saying, “the "substantial further progress" test has been met for inflation. There has also been clear progress toward maximum employment.” At the FOMC's recent July meeting, the Chairman was of the view that it could be appropriate to start reducing the pace of asset purchases this year. But the Federal Open Market Committee decided to continue the asset purchases at the current pace until ‘substantial further progress’ toward maximum employment and price stability goals is observed.

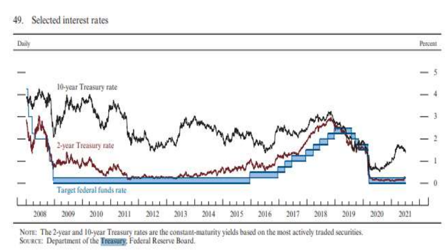
Given the prevailing concerns over the further spread of the Delta variant, the Chairman reiterated, “Even after our asset purchases end, our elevated holdings of longer-term securities will continue to support accommodative financial conditions. The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test.”

Presently, the prospects for global economy have improved considerably, but with a widened gap across economies. The scale of the economic disruption from the pandemic has been exceptionally large for some economies, and their recovery is likely to be prolonged. In the United States over the first half of 2021, progress on vaccinations has led to a strong economic growth and resuming of businesses, supported by accommodative monetary and fiscal policy. However, the effects of the COVID-19 pandemic have continued to weigh on the U.S. economy, and employment has remained well below pre-pandemic levels. Furthermore, shortages of material inputs and difficulties in hiring have held down activity in a number of industries. In part because of these bottlenecks and other largely transitory factors, PCE (personal consumption expenditures) price index rose 4.2% over the 12 months ending in July.




Source: Federal Reserve Monetary Policy Report (July 2021)

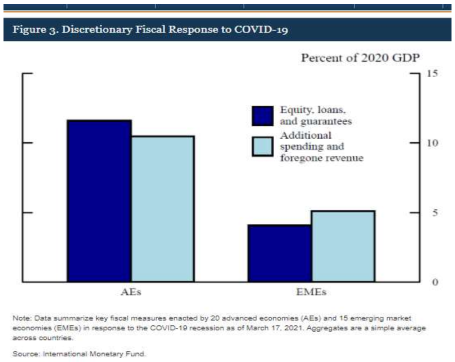


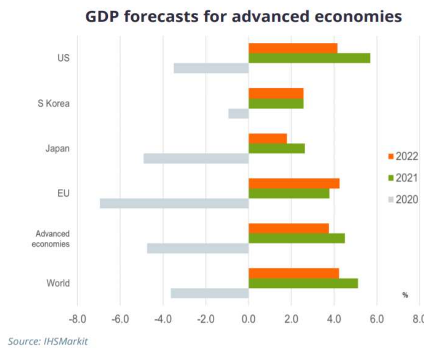

Source: Federal Reserve Monetary Policy Report (July 2021)

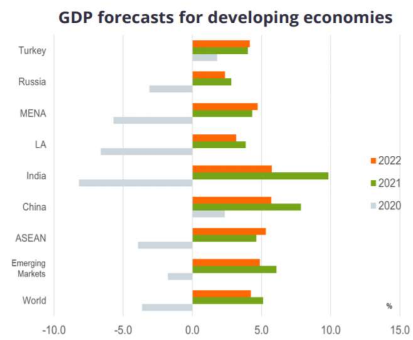
The Federal Open Market Committee (FOMC) had also held its policy rate near zero and continued to purchase Treasury securities and agency mortgage-backed securities to support the economic recovery. These measures, along with the Committee’s guidance on interest rates and the Federal Reserve’s balance sheet, ensured that monetary policy continues to deliver powerful support to the economy until the recovery is complete.

The downturn in global economic activity caused by the COVID-19 pandemic was unique both for its causes and for its severity. The central banks and the policymakers have taken unprecedented actions to mitigate the economic and financial disruptions precipitated by the pandemic. According to IMF, discretionary fiscal responses amounted to more than 20% of GDP in advanced economies and almost 10% in emerging ones. These fiscal interventions provided extraordinary support to the balance sheets of households and business. Central banks, on the other hand, intervened to support market functioning and enhance credit accessibility, easing the widespread financial turmoil. Accommodative monetary policy measures, massive liquidity injections and targeted credit support contributed to stabilize financial conditions and reduce volatility across many countries.

According to HIS Markit, global real GDP is projected to increase 5.3% in 2021 and 4.3% in 2022 before settling to a 3.1% growth pace in 2023-25, exhibiting varied performances across regions with Asia-Pacific and North America leading while Europe and Latin America lagging.



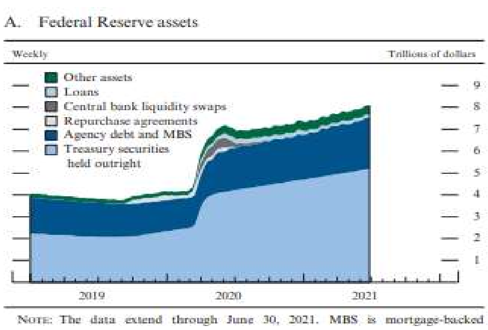

Source: IHS Market Source: IHS Market

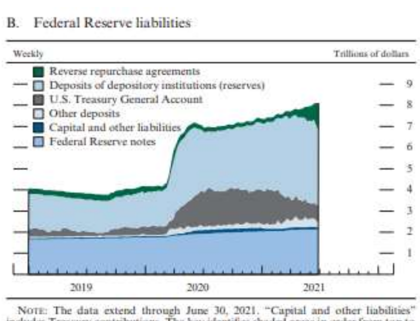
## Continued Accommodative Stance

The Federal Reserve's monetary policy responses to the COVID crisis were unprecedented in their scale, scope, and speed. The Fed acted decisively and with dispatch to deploy all the tools in its conventional kit such as cutting interest rates, offering forward guidance, and rescaling and restarting programs to purchase Treasury securities and agency mortgage-backed securities (MBS) as well as repurchase agreement (repo) operations, along with measures to provide liquidity and funding to support money market functioning.

Apart from these conventional monetary policy measures, the Federal Reserve launched a number of facilities to support more directly the flow of credit to households, businesses, and state and local governments. They also made temporary recalibrations to regulations and supervisory practices to encourage and incentivize banks to support the flow of credit to their household and business customers. These measures, taken together and in tandem with a historic fiscal policy response, provided crucial support to the economy in 2020 and are continuing to contribute to what is expected to be a robust economic recovery in 2021.

The size of the Federal Reserve's balance sheet has continued to grow, reflecting purchases of U.S. Treasury securities and agency mortgage-backed securities. According to Federal Reserve Monetary Policy Report (July 2021), their balance sheet has grown to $8.1 trillion from $7.4 trillion at the end of January, reflecting continued asset purchases to help foster smooth market functioning and accommodative financial conditions. Even the principal payments received from agency MBS and agency debt continue to be reinvested into agency MBS. As net asset purchases proceed at a pace of $120 billion per month, the Federal Reserve's total liabilities have also increased correspondingly. Reserves, being the largest liability on the Federal Reserve's balance sheet have increased significantly to around $4 trillion, mostly because of asset purchases and the large drawdown in the Treasury General Account. However, reserves have been relatively stable given a substantial increase in the use of the overnight reverse repurchase agreement facility.



The prevailing monetary policy remains very accommodative in the advanced economies, as central banks are primarily focused on supporting growth and view the recent inflationary pressures as transitory. Policy interest rates have been unchanged, and forward guidance has emphasized that they would likely remain at their current low levels for a considerable time. The US Federal Reserve is also committing to use its full range of tools to maximize employment and maintain price stability, thereby supporting the economy in these challenging times.

The Federal Open Market Committee seeks to achieve its dual mandate of easing job market and keeping inflation at the rate of 2% over the longer run. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved. In the recently concluded Jackson Hole meeting Jerome Powell remarked, "We have said that we will continue to hold the target range for the federal funds rate at its current level until the economy reaches conditions consistent with maximum employment, and inflation has reached 2 percent and is on track to moderately exceed 2 percent for some time. We have much ground to cover to reach maximum employment, and time will tell whether we have reached 2 percent inflation on a sustainable basis."

## FOMC July Updates

In perhaps the most watched Federal Reserve meeting in a long time - amidst soaring inflation expectations and market jitters on possible monetary policy tightening – the Federal Open Market Committee decided to left their benchmark interest rate unchanged near zero and again vowed to use all their tools to support the U.S. economy amid a shaky recovery from the pandemic. Furthermore, in order to ensure sufficient liquidity for households and businesses, the Fed reaffirmed its commitment to continue its purchases of Treasury securities, and agency residential and commercial mortgage-backed securities, at least at the current pace of $80 billion per month and $40 billion per month, respectively. Additionally, the Bank will continue to offer large-scale overnight and term repurchase agreement operations. Nevertheless, with inflation soaring quickly and some employment measurements finally starting to show sustained improvement, it did hint at considering tapering in the future. Even in his Friday speech, Powell said he along with major other participants are of the opinion to consider reducing the pace of the asset purchases this year if the economy evolves broadly as anticipated.

On the inflation front, Powell reiterated his views that the inflation spike may not be sustainable. According to Powell, higher inflation effect may be largely transitory and merely tied to the reopening of the economy where overwhelmed manufacturers surge in pent-up demand and drove cost of supplies and labor higher. In the Friday meeting, Powell said that inflation at the current level is definitely a cause for concern, but reiterated that "concern is tempered by a number of factors that suggest that these elevated readings are likely to prove temporary."

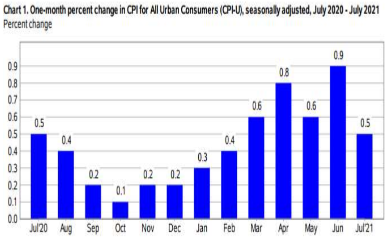
At a macro level, Fed has given a rather emphatic signal that it had begun the process of scaling back its massive monetary support for the American economy. However, the statement continued to be ambiguous about the pace and timing of the taper or the rate hikes. The Fed's statement is largely viewed as setting the process of taper in motion, irrespective of when it actually happens. In fact, minutes from the Fed meeting showed that there's increased appetite to discuss tapering bond purchases. But short-term interest rate hikes likely remain far away.

## Inflation

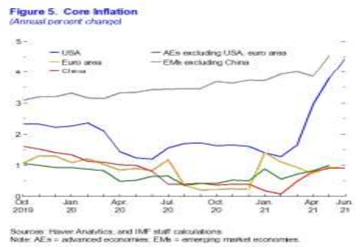
Last year, Chairman Jerome Powell warned that the central bank would allow prices to rise above the Fed's 2% target for a moderate period of time before intervening. The rationale was that inflation had been too low over the past decade following the Great Recession, and so by allowing prices to slip above the target level for a certain period, the Fed would have a better chance of actually meeting its price target rather than continually undershooting it.

But presently, the Fed faces a different problem. Consumer price inflation has increased notably this spring as pent-up demand has run up against supply-chain bottlenecks and tight labor markets. The latest CPI inflation data showed prices in July rose by 5.4% over the past 12 months, after overshooting the Fed's target level in April, May and June as well.

It largely seems that higher inflation will likely be with us through the rest of the year. However, the Fed isn't in a huge rush to step in, though. They expect that these extraordinary circumstances shall pass, and then supply and demand would move closer to equilibrium, and ensure price stability.



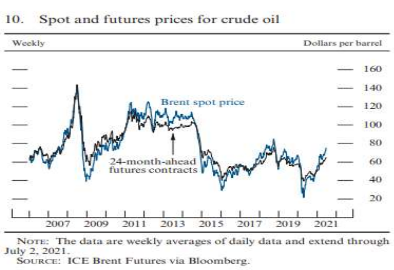


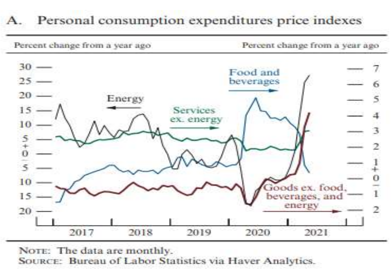



Source: U.S. Bureau of Labor Statistics

The sharp rise in inflation so far this year has raised the question of whether the recent elevated pace of price increases will abate without calling for a change in the path of monetary policy or would instead be followed by a period of higher inflation pressures and call for a change in the accommodative stance. The latter situation could arise if longer-term inflation expectations were to rise persistently above levels which are not well anchored at the Committee's 2 percent longer-run inflation objective.

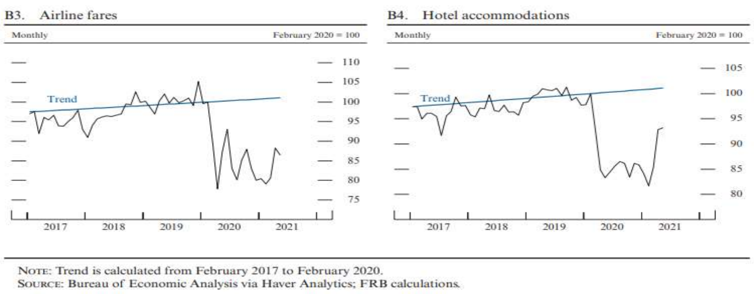
After a sharp recovery in late 2020 and early 2021, oil prices have risen substantially hovering over $10 per barrel in the past few months. Even though oil consumption is still well below pre-pandemic levels, oil production is also held-back, but oil prices are now above pre-pandemic levels. However, oil demand continues to be held back by the slow recovery in travel and commuting. Meanwhile, OPEC nations and its partners, notably Russia, have only slowly increased their production toward pre-pandemic levels, offsetting the effect of weak demand.




Increased import prices has contributed significantly to the step-up in consumer price inflation in the first half of 2021, boosted by commodity prices, which rose apace to strong demand for goods. The effects of higher import prices have also been exacerbated by bottlenecks abroad that have raised transport costs. However, largely sharp price increases for goods have been concentrated among a subset of products experiencing strong demand coupled with capacity constraints.

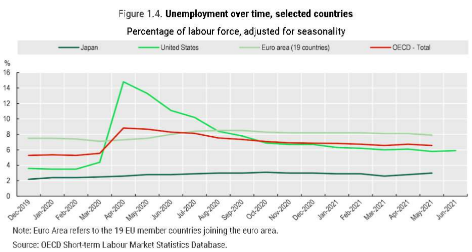
Regarding services prices, demand for certain non-energy services that were severely curtailed by social distancing during the pandemic has surged this spring as the vaccines have become widely available. The resurgence in demand for these services is pushing up prices this year. As two prominent examples, airline fares and prices for hotel accommodations have jumped since the beginning of the year but so far remain somewhat below their pre-Covid trends.

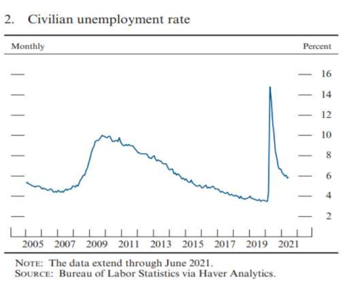



Overall, an important part of the rise in inflation this spring appears to be due to a surge in demand, including the rebound in travel-related spending, running up against short-run production bottlenecks and hiring difficulties. As these extraordinary circumstances pass, supply and demand should become better aligned, and inflation is widely expected to move down towards the FOMC's 2 percent longer run goal. That said, upside risks to the inflation outlook in the near term have increased.

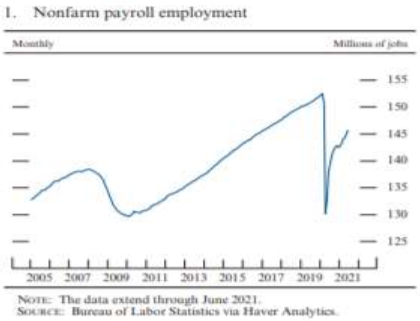
## Labor Market

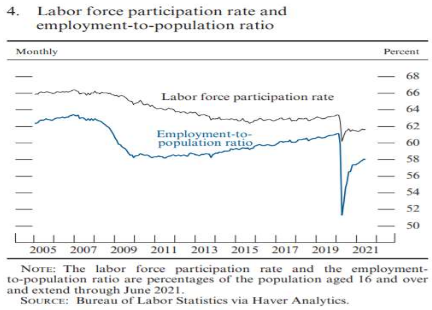
The impact of the COVID-19 crisis on labor markets across economies has been profound. In April 2020, following the onset of the crisis, the unemployment rate in OECD countries saw an unprecedented 3% increase to reach 8.8% – the highest unemployment rate seen in a decade. In the United States alone, in just one month, the number of people in unemployment swelled by nearly 16 million, to reach over 23 million in April 2020. Moreover, even in March 2021those unemployed for at least 6 months accounted for 43.4% of the total unemployed population, approaching the historical peak of 45.5% in April, to fall slightly to reach 42.1% in June in the aftermath of the improvement of the US economy.




However, the economic recovery has picked up speed. The labor market has shown significant signs of improvement in the first half of the year as the economy reopened and activity rebounded. Indicators of consumption activity have risen, while strong household income growth and a gradual relaxation of containment measures is boosting spending. But household saving rates also remain elevated compared to pre-pandemic levels. Payroll employment increased by 3.2 million jobs in the first half of 2021, driven by a 1.6 million job gain in virus-sensitive sectors like leisure and hospitality, where the largest employment losses occurred last year.



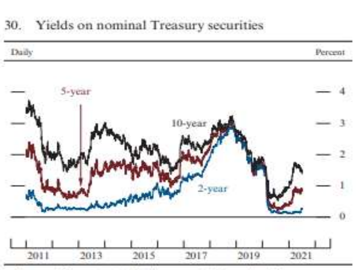

It was observed that with economic activity rebounding, labor demand rose abruptly in the spring, while the supply of labor struggled to keep up. Employers reported widespread hiring difficulties, job openings jumped to about 30% above the average level for 2019, and the ratio of job openings to job seekers surged. Faced with a challenging environment for hiring along with a dwindling pool of temporarily laid-off workers to recall, many employers raised wages to attract new workers. Additionally, enhanced unemployment benefits have allowed potential workers to be more selective and reduce the intensity of their job search.

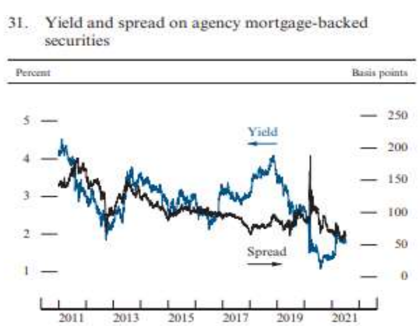
Real GDP growth is expected to pick up strongly in 2021, with fiscal support pushing household consumption growth sharply higher. At the same time, the reopening of the economy due to widespread vaccination of the population will enable activity in more sectors to return to normal. Export activity will also recover as the virus is better controlled in major trading partner economies. Stronger demand for labor will translate into a lower unemployment rate, even as more discouraged workers are enticed back into the labor market.

While the unemployment rate has dropped to 5.4% in July, well off its peak of 14.8% in April 2020, it's still almost two percentage points higher than before the onset of the pandemic. Many of the factors constraining labor force participation should gradually abate in the coming months, following which the overall participation rate should steadily increase, while the demographic disparities in labor force participation that widened during the pandemic would probably continue to narrow. The full effect of the pandemic on the structure of the labor market remains to be seen, and the characteristics of maximum employment could likely be different from those of early 2020.

## Sovereign yields and Equity prices

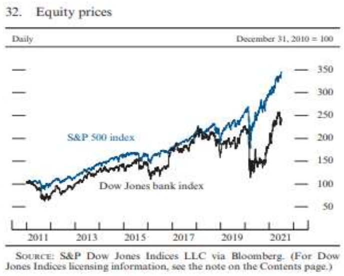
Yields on nominal Treasury securities at longer maturities have relatively remained stable mid-February. Concurrently, volatility of near-term swap options on 10-year swap interest rates, that measures near-term uncertainty about longer-term interest rates have also remained roughly unchanged since February. However, spreads of corporate bond yields over comparable maturity Treasury securities have narrowed modestly and stand somewhat below the levels prevailing at the onset of the pandemic. This is largely due to visible signs of improvement in the credit quality of nonfinancial firms. Also, yields on 30-year agency mortgage-backed securities determining the pricing of home mortgages have remained relatively stable since mid-February. However, the yield on comparable-maturity Treasury securities increased a bit, leaving their spread modestly lower.

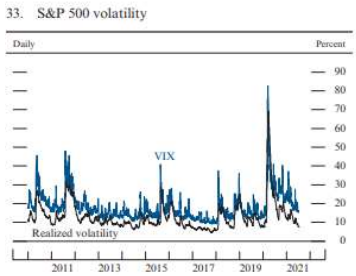



Source: Department of the Treasury; J.P. Morgan.

Broad stock price indexes have continued to rise since the first half of 2021. They have been buoyed by the strong corporate earnings, optimism about the pace of vaccinations, additional fiscal stimulus, and signs of a faster pace of economic recovery that outweighed concerns about high valuations, and also increased investor risk appetite.




Source: Cboe Volatility Index via Bloomberg; Fed Board staff estimates.

The high asset prices in part reflect the continued low level of treasury yields. However, valuations for some assets are elevated relative to historical norms even after incorporating historical measures of treasury yields. Given the scenario, asset prices may be vulnerable to significant declines if investor risk appetite fall, interest rates rise unexpectedly, or the recovery stall.

## The Path Ahead

In the year ahead, as more vaccines roll off the production line, more people gets jabbed, and more economies gradually reopen, policymakers need to engineer a fundamental shift with growth-oriented reforms in order to prevent their economies from collapsing. Prioritizing health spending, providing well-targeted fiscal support, and maintaining accommodative monetary policy as warranted, while monitoring financial stability risks, remain key while the pandemic continues. As the recovery progresses, policymakers would need to emphasize measures that limit economic scarring from the crisis, shrink inequality, and boost productive capacity (such as public investment). The transition from support measures would need to be managed carefully to avoid sudden cliffs that could derail the recovery. Particular attention to reallocation in labor markets will be important.

Policy settings that promote sustained output growth once the impact from temporary stimulus has waned should now be the priority. Spending on environmental, transportation and social infrastructure is needed. Infrastructure investment that reduces carbon emissions should be coupled with further progress in pricing carbon content. Reducing and eventually removing fossil fuel subsidies and lowering the taxation of renewable energy should be the important priorities. As the economy further recovers, labor reallocation processes and the prospects of the most vulnerable will benefit from upgrading access to community colleges, apprenticeship, life-long learning and job placement services.

Given the uncertainty in growth prospects, the Federal Reserve would largely be hesitant to taper monthly bond purchases before it is clear that inflation has taken off. But there are significant risks involved in the prolonged quantitative easing. In a recent Financial Times article, Dr.Raghuram G. Rajan referring the July Fed meet where Chairman Powell hinted at ending the $120 billion monthly bond-buying program, talked about the frothier valuation of stock prices and other securities. He wrote, "One common factor driving up both stock and bond prices (thus lowering bond yields) could be asset managers' search for yield, owing to the conditions created by extremely accommodative monetary policies…….Phasing out quantitative easing (QE) is the first step toward monetary-policy normalization, which itself is necessary to alleviate the pressure on asset managers to produce impossible returns in a low-yield environment."

Lastly, there is the danger of market turbulence that could be triggered by the discovery of new virus variants, transitory swings in inflation, or the possibility that major central banks raise interest rates sooner than expected. Such market reaction could tighten global financing conditions in unexpected ways. While central banks can't do anything to change the course of the pandemic, they should pre-empt the possibility of sharp swings in borrowing costs. Moreover, they should avoid prematurely tightening policies when faced with transitory inflation pressures but should be prepared to move quickly if inflation expectations show signs of de-anchoring.

## Disclosure & Disclaimer

CD Equisearch Private Limited (hereinafter referred to as **'CD Equi'**) is a Member registered with National Stock Exchange of India Limited, Bombay Stock Exchange Limited and Metropolitan Stock Exchange of India Limited (Formerly known as MCX Stock Exchange Limited). CD Equi is also registered as Depository Participant with CDSL and AMFI registered Mutual Fund Advisor. The associates of CD Equi are engaged in activities relating to NBFC-ND - Financing and Investment, Commodity Broking, Real Estate, etc.

CD Equi is registered under SEBI (Research Analysts) Regulations, 2014 with SEBI Registration no INH300002274. Further, CD Equi hereby declares that –

- No disciplinary action has been taken against CD Equi by any of the regulatory authorities.
- CD Equi/its associates/research analysts do not have any financial interest/beneficial interest of more than one percent/material conflict of interest in the subject company(s) **(*kindly disclose if otherwise*)**.
- CD Equi/its associates/research analysts have not received any compensation from the subject company(s) during the past twelve months.
- CD Equi/its research analysts has not served as an officer, director or employee of company covered by analysts and has not been engaged in market making activity of the company covered by analysts.

This document is solely for the personal information of the recipient and must not be singularly used as the basis of any investment decision. Nothing in this document should be construed as investment or financial advice. Each recipient of this document should make such investigations as they deem necessary to arrive at an independent evaluation of an investment in the securities of the companies referred to in this document (including the merits and risks involved) and should consult their own advisors to determine the merits and risks of such an investment.

Reports based on technical and derivative analysis center on studying charts of a stock's price movement, outstanding positions and trading volume, as opposed to focusing on a company's fundamentals and as such, may not match with a report on a company's fundamentals.

The information in this document has been printed on the basis of publicly available information, internal data and other reliable sources believed to be true but we do not represent that it is accurate or complete and it should not be relied on as such, as this document is for general guidance only. CD Equi or any of its affiliates/group companies shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. CD Equi has not independently verified all the information contained within this document. Accordingly, we cannot testify nor make any representation or warranty, express or implied, to the accuracy, contents or data contained within this document.

While, CD Equi endeavors to update on a reasonable basis the information discussed in this material, there may be regulatory compliance or other reasons that prevent us from doing so.

This document is being supplied to you solely for your information and its contents, information or data may not be reproduced, redistributed or passed on, directly or indirectly. Neither, CD Equi nor its directors, employees or affiliates shall be liable for any loss or damage that may arise from or in connection with the use of this information.

CD Equisearch Private Limited (CIN: U67120WB1995PTC071521)
Registered Office: 37, Shakespeare Sarani, 3rdFloor, Kolkata – 700 017; Phone: +91(33) 4488 0000; Fax: +91(33) 2289 2557 Corporate Office: 10, Vasawani Mansion, 5th Floor, DinshawWachha Road, Churchgate, Mumbai – 400 020. Phone: +91(22) 2283 0652/0653; Fax: +91(22) 2283, 2276
Website: www.cdequi.com; Email: research@cdequi.com