

What the Fed's rate hike comments may mean for the economic recovery and investors



Kristina Hooper
Chief Global Market Strategist

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There were some interesting developments last week that gave some market watchers reasons for concern. However, I believe they are positive.

First of all, in a speech last week Federal Reserve (Fed) Vice Chair Richard Clarida suggested that tapering could be announced soon, and that he expects interest rate hikes to begin in early 2023. Many perceived these comments as hawkish — but in my opinion, they are far from it. Rather, I believe they are rather dovish given the progress the US has made thus far in economic growth in general, and employment in particular. I fully expect the Fed to announce its plans for tapering in the late summer/early fall (probably at its Jackson Hole meeting later this month) and to start tapering by the end of 2021. I think it is more than reasonable to start rate hikes in early 2023 — but I still think the Fed may need to start hiking rates in late 2022. That is still a wonderfully accommodative environment.

So what has investors rattled about impending monetary policy normalization? Most likely, it's because it would come relatively quickly after the Fed began easing in response to the pandemic. For many, the frame of reference may be the last crisis (the global financial crisis [GFC]), when it took years from the start of easing for the Fed to begin normalizing monetary policy. In that case, quantitative easing started in December 2008 and tapering began in December 2013, and the Fed started raising the federal funds rate in December 2015 after starting to cut rates in September 2007.¹

This time around, the transition from easing to tightening would occur on a far more compressed timeline. But keep in mind this crisis has been extremely different than the last one. The post-GFC recovery was rather anemic for years — especially when it came to jobs — while this recovery is occurring at relative warp speed in comparison. The level of fiscal stimulus this time around has certainly been a factor; in the GFC, fiscal stimulus in the US comprised about 6% of GDP, while during the pandemic it has comprised 25% of GDP thus far.² But it's also the nature of the crisis and its solution, with the speedy development of vaccines still a game changer that has jolted the economy into a strong economic rebound despite difficulties with the rollout of vaccines and the spread of COVID-19 variants. In addition, I believe the Fed is clearly doing a better job of messaging its policy changes this time around, having learned from the past.

Second, the US jobs report for July came out and it was a blowout. There was a large, better-than-expected increase in jobs, especially leisure and hospitality — and don't forget this follows on the heels of a very strong June jobs report (which was revised upward). But the July jobs report showed significant growth in wages as well, especially hospitality and leisure. And so, while most rejoiced at the jobs report, some expressed concern about inflation. Admittedly, I have said for a while that we need to follow wage growth closely because it is stickier and can result in persistent inflation. However, I do believe wage growth is less "sticky" in the leisure and hospitality space given the high level of employee turnover, which allows for employers to adjust wages far more quickly. We will want to continue to follow wage growth closely, but recognize that the labor market has not normalized yet given that some key causes of labor scarcity — including childcare and COVID-19 fears — are still present, at least for the time being. There is such a high level of demand for labor, as evidenced by today's Job Openings and Labor Turnover Survey (JOLTS) report, given the unique circumstances of the recovery.

Not surprisingly, the 10-year US Treasury yield made a nice surge upward to nearly 1.3% on Friday, after a significant slide for several weeks before. From my perspective, that is healthy and is keeping with my view that the 10-year yield will end the year closer to 2% than 1%.

So what am I thinking about this week? I wouldn't say I'm "worried" about the following, but I am certainly keeping my eye on a few things:

- **COVID-19 infections and vaccinations:** COVID-19 is spreading in many countries, including the US, with hospitalizations on the rise. Vaccination efforts continue in emerging markets but not nearly as quickly as health officials would like to see. The US has benefited from vaccine abundance, and in recent weeks we have seen more people getting vaccinated in states where there has been high vaccine reluctance. Thus far, the resurgence of COVID-19 has not had a material impact on the US economy but that might change, so we will want to follow it closely.

Many other countries haven't had as swift a vaccine rollout as the US. I am particularly worried about countries in southeast Asia that were able to handily control the spread of COVID-19 in the last year but are now experiencing a substantial surge in infections. This could in turn result in further supply chain disruptions that could be quite problematic; it's already happening in countries such as Vietnam. Keep in mind that this is a real problem for the manufacturing sector, as evidenced in the most recent ISM manufacturing survey.³ While one survey respondent in the electronics industry shared that supply chain issues are slowly improving, many other respondents are still facing challenges. One respondent from the machinery industry explained, "Supply chain continues to be extremely challenging in a variety of categories. Having to place orders months ahead of time just to get a place in line."³

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- **University of Michigan five-year inflation expectations:** I know the July US consumer price index (CPI) print will come out this week, but what I care far more about is preliminary inflation expectations for August — not one year out, as that would reflect more temporary inflation, but further out. And the Fed cares about longer-term inflation expectations too. It seems consumers are less anxious about inflation, as it peaked at 3% in May and has fallen slightly since then.⁴ I want to be sure it remains on a downward trajectory.

Looking ahead, I expect more volatility for stocks — and Treasuries — as we move through August. We are likely to hear more “Fedspeak,” likely foreshadowing a taper announcement. I don’t expect a taper tantrum like we saw in 2013, but I wouldn’t be surprised by some market fluctuations. In addition, negative news about COVID-19 could, of course, also add substantially to volatility.

Notes

¹Federal Reserve

²IMF Policy Tracker, IMF GDP Data, Atlantic Council, DE Data Wrapper, Invesco. Calculations based on data at various national release and announcement dates, and Atlantic Council as of March 31, 2021. 2009 based on IMF, Eurostat and G20 data. NB: Calculations exclude deferrals and guarantees; include discretionary fiscal support programs (aside from “automatic stabilizers”); announced and implemented programs — all scaled against 2008 and 2019 GDP, respectively.

³ISM July Manufacturing Survey

⁴Surveys of Consumers, University of Michigan

Important information

Tapering is the gradual winding down of central bank activities that aimed to reverse poor economic conditions.

Quantitative easing (QE) is a monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective.

Quantitative tightening (QT) is a monetary policy used by central banks to normalize balance sheets.

The federal funds rate is the rate at which banks lend balances to each other overnight.

Gross domestic product (GDP) is a broad indicator of a region’s economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The consumer price index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

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