MARKETS AND ECONOMY

Fed to weigh growth, inflation, Delta variant uncertainty at July meeting

By: Eric Stein, CFA | July 26, 2021

Boston - Monetary policymakers at the U.S. Federal Reserve have a lot on their minds ahead of their meeting on July 27 and July 28. The economy is generally stronger than we perceived a year or so ago — certainly the rebound from the worst of the COVID-19 pandemic has outpaced the initial expectations.

However, the *delta* (or rate of change) of growth — not to be confused with the COVID-19 Delta variant! — has begun to slow somewhat. In large part, that is to be expected, given that the initial 12-month comparisons for GDP growth reflected the low base of economic activity at the height of the pandemic and the massive stimulus and momentum that followed.

Nevertheless, some increment of what appears to be a slowing rate of growth can clearly be attributed to the new uncertainties around the delta variant. At the margin, some of the "higher frequency" data — like the July 22 weekly jobless claims report — is getting weaker. The tail risk that this variant of COVID-19 will cause another partial shutdown is not my base case. But the risk, in my view, is certainly higher than it was a month ago.

Inflation's surprising strength

Inflation reports continue to come in higher than expected, and the big debate in the market, among economists and at the Fed, is whether it is transitory or more durable. I don't think it's too soon to consider the sequencing of a more hawkish adjustment of policy to address tapering and Fed balance sheet growth.

July's FOMC meeting will undoubtedly address those issues, and will be followed by a press conference, as usual. On August 26, the Fed holds its annual meeting in Jackson Hole, Wyoming, with its September meeting following a few weeks later. It seems there could be a pre-announcement at either of those, then a formal announcement in November about tapering to start in December. Or the last two steps might be pushed back to a December/January framework.

Assuming the Fed does initiate its tapering, there are important nuances to consider in terms of how that would happen and the composition of purchases to be reduced. There has been a fair bit of speculation in the market that tapering of mortgage-backed securities (MBS) would take place sooner or at a faster pace than for U.S. Treasurys, in an attempt to take some of the steam out of the hot real estate market. But that met with pushback from some Fed officials, who indicated that tapering of Treasurys and MBS would be evenly split.

Bottom line: After many months of speculation about a postpandemic Fed monetary policy, I believe the pace of progress from "talking" to "doing" is very likely to accelerate in the second half of the year.

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