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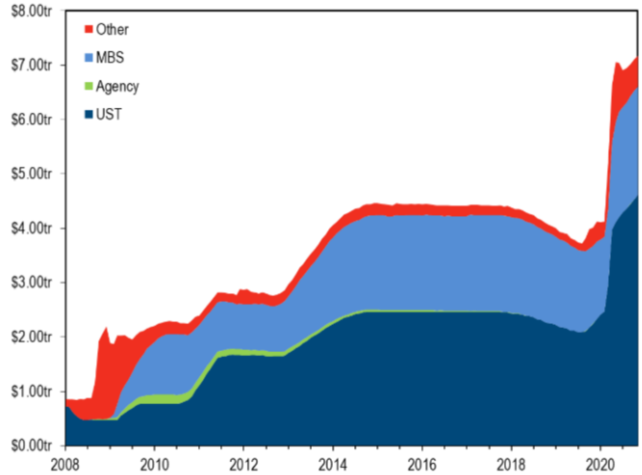
Fed to Offer Forward Guidance

The November FOMC meeting minutes showed officials' efforts to begin to prepare the market for potential adjustments to the Fed's asset purchase program. The discussion last month, however, offered little clarity of what changes may come, if any, or the timeline for any adjustments with the final meeting of year just five days away. Some officials suggested the Committee could ramp up purchases from the current $120 billion monthly pace if deemed necessary to provide further accommodation, while others indicated a preference for extending the duration without increasing the size of purchases. At present, however, most participants generally saw the current pace and composition of the central bank's securities program as *"effective in fostering accommodative financial conditions."* Although, it was noted that circumstances could *"shift"* to warrant future adjustments.

And indeed, there has been a *"shift"* in the U.S. economy since last month's Fed meeting. Front and center is the second-round resurgence of COVID-19 that has gained momentum with caseloads rising more than 5M in the past four weeks and prompting more than 40 states to enact further safety measures to help stem the spread of the virus. And with more and more businesses facing additional restrictions and lockdowns, many have been forced to (again) alter activities, cut hours, temporarily shut down, or permanently close their doors, reversing much of the third-quarter momentum in the labor market as well as the broader economy. Additionally, in November, the White House announced plans to allow some emergency Fed programs, including the Main Street Lending Program, to expire at year-end.

For now, this change in circumstance – while sizable and likely to be acknowledged in the December statement – is unlikely to prompt further policy action from the Federal Reserve at next week's meeting. First off, over the past nine months, the Fed has already purchased more than $2.7T in assets, growing the balance sheet to over $7T. Additionally, coupled with a number of lending and liquidity programs, as well as the low level of longer-term rates, some remain skeptical that additional purchases would do any further good. Instead, they fear a significant expansion in asset holdings could have potential – unintended – consequences, particularly in the housing market. Second, Fed officials have been crystal clear in their view of the economy's need for further *fiscal* aid. Given the Fed's unprecedented support throughout the pandemic, central bankers have now passed the proverbial baton to those in Washington to step up and act. Federal Reserve Chairman Jerome Powell has repeatedly called on Congress to come to an agreement on a coronavirus relief package. Without further aid, the Chairman has warned of tragic economic consequences as the recovery still has a *"long way to go."* Even with more recent progress on the vaccine front, during this month's testimony before the Committee on Banking, Housing, and Urban Affairs, Powell cautioned the economic outlook was *"extraordinarily uncertain"* and fragile.

While no further policy action or adjustments to asset purchases is expected next week, at the very least Fed members will continue to contemplate the potential for further future policy intervention. Come 2021, should the economy slow more than expected as a result of a potentially stronger than expected resurgence of the virus, or unforeseen challenges in the vaccine distribution process, or a lack of action in the form of relief aid from officials in Washington, the central bank has been clear in its willingness to implement further support including ramping up purchases to ensure markets continue to function smoothly. Until then, members are more likely to focus on providing additional clarity around the asset purchase program itself, as well as the metrics used to judge its effectiveness.



*Other includes discount window lending; lending to other institutions; assets of limited liability companies (LLCs) that have been consolidated onto the Federal Reserve's balance sheet, and foreign currency holdings associated with reciprocal currency arrangements with other central banks (foreign central bank liquidity swaps).

Source: Federal Reserve, Haver Analytics

The September FOMC statement indicated that asset purchases would continue *"over coming months."* Two months later, according to the November meeting minutes, most participants argued in favor of updating this guidance and implementing qualitative outcome-based metrics including an expected timeline for conducting – and concluding – asset purchases. Participants argued updating guidance would not only be an avenue to align the market's expectation with the Committee's, but a way to reinforce the Fed's commitment to providing additional and ongoing support to the domestic economy.

What would such guidance look like? It would expectedly be consistent with the Committee's foreword guidance for the federal funds rate that remains contingent on three previsions: labor market conditions consistent with maximum employment, reaching 2% inflation, and expectations inflation will moderately exceed 2% price growth for some time. Updated guidance on asset purchases could then be an extension of such, noting increases in securities holdings will continue until the Committee is confident or satisfied with progress towards these conditions, essentially acknowledging the likely progression of policy adjustments. As the November minutes show, the Fed will likely end balance sheet expansion first before raising rates: *"Most participants judged that the guidance for asset purchases should imply that increases in the Committee's securities holdings would taper and cease sometime before the Committee would begin to raise the target range for the federal funds rate."*

In addition to adjustments in guidance, the Fed is also slated to release updated forecasts at the December 16 meeting. In September, following a slew of better-than-expected data translating into a faster pace of recovery than previously expected, the Fed upgraded its outlook for near-term growth in 2020 from -6.5% to a lesser decline of 3.7%. This month's update is more likely to move in the opposite direction with domestic activity already showing sizable signs of slowing amid a second-round resurgence of the virus and subsequent policy measures restricting market activity into the end of the year. Growth forecasts for 2021 and 2022, however, may be revised slightly higher fueled by optimism a near-term vaccine could potentially thrust the market back to some semblance of normal by next fall if all goes according to plan from an approval, production, and distribution standpoint – a bold assumption.

Also a reflection of waning momentum, particularly in the labor market, the Fed is likely to maintain a forecast near its current projection for a roughly 7.5% unemployment rate in 2020 and remaining below 6% thereafter. Finally, given the extended timeline for a *"full recovery"* back to pre-pandemic levels both at home and globally, the Committee's inflation forecast is likely to remain subdued for some time with prices not pushing back to the Fed's 2% target until late 2022, or thereafter.

-Lindsey Piegza, Ph.D., Chief Economist

Glossary

FOMC – Federal Open Market Committee

SEP – Summary of Economic Projections