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Interest Rates and Macroeconomic Update

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The Fed Update

Despite the ongoing prevalence of the COVID-19 pandemic, many countries are starting to reopen and return to a normal state of living. With the influx in vaccine production and significant rollout in the past months, economies are beginning to recover. The markets are an example of this, since the crash in March 2020, the markets have shown significant recovery, with the S&P 500 and Dow Jones Industrial both rallying over 80%.

The US has set in place a variety of measures to aid in the recovery of the overall economy. In addition to over $2T dollars in support packages given to Americans, the Fed has put in place changes to monetary policy to support the recovery. The two main policy changes being cutting interest rates to near zero levels and extensive quantitative easing (QE). As the pandemic continues, the benefits of the unconventional monetary policies are taking shape, evident by a 6.4% increase in GDP for Q1 2021. However, there is a new issue on the rise. An increased amount of government support via the Biden administration's new CARES Act is sparking inflation concerns. With unemployment figures staying relatively constant and an increasingly volatile market, Americans are once again puzzled at the state of their economy.

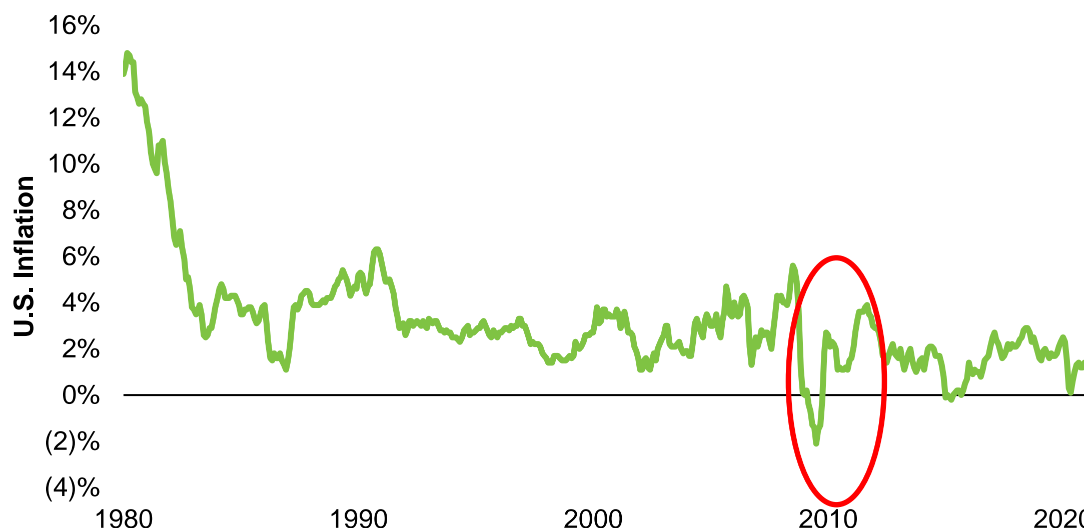
On Wednesday, June 16, 2021, the Chairman of the Federal Reserve (Fed), Jerome Powell, held a press conference detailing the Fed's forward-looking plan on interest rate levels, inflation expectations, and the bond–buyback program. The meeting was an essential indicator to US citizens on the economy's future and how monetary policy will be implemented if inflationary spikes are not transitory, meaning a temporary increase in the prices of goods and services leading to a short-term spike in the inflation rate. The update opened with positive news surrounding the current economic state of the country: increasing household spending and strengthening in both the housing sector and business investment, to name a few. However, an underwhelming number of jobs created exacerbating expectations of slowing supply chains in various industries remains a concern, especially considering low participation levels in the labor market. From a policy standpoint, the Fed remained consistent keeping interest rates near zero; however, a rate increase may be on the horizon sooner than expected especially if inflation continues to rise. Regarding QE, the Fed announced it would continue to increase its holdings of treasury securities by $80B per month and agency mortgage-backed securities by $40B per month.

Looking Back Through History

Although the measures leveraged by the Fed today are unconventional, they have been used in the past.

A similar action plan existed during the 2008 financial crisis. In early 2007, rising unemployment rate led the Fed to cut interest rates. The cuts were steady and had stopped in June 2008, after which the policy rate was held to 2%. In addition to the interest rate cuts, the Fed introduced QE into the mix. QE is when a central bank will buy large amounts of securities, such as government bonds, to increase the money supply and spur economic activity. However, one risk that quantitative easing brings is increased inflation, as has been shown by recent price trends. Although inflationary concerns are the common denominator when comparing the financial crisis to today's economic situation there are a few key differences to highlight.

Exhibit 1: U.S Inflation rate from 1980 – 2021, with a focus on the deflationary period in 2009



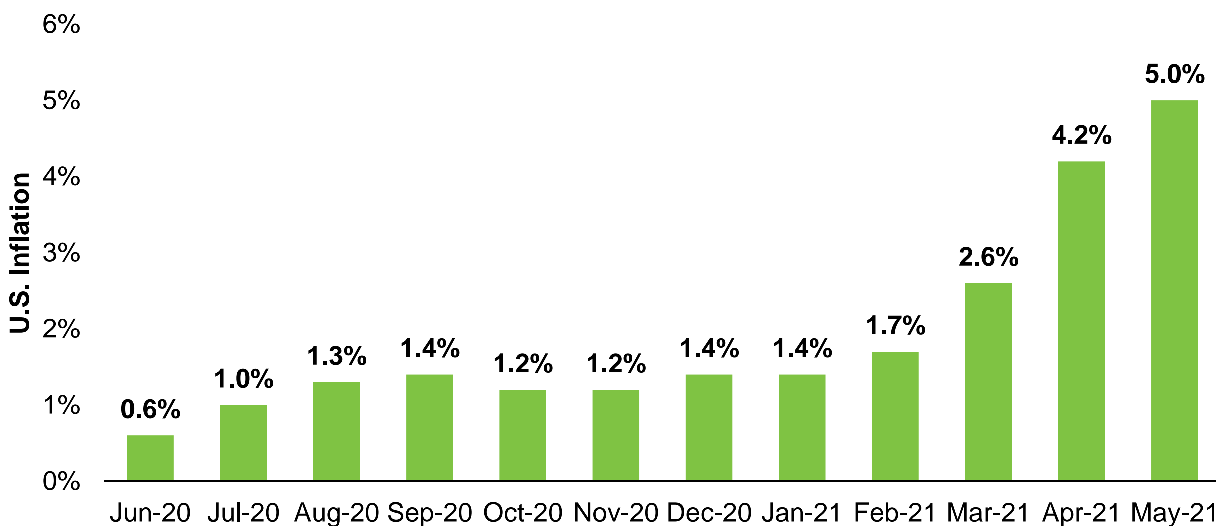
At first glance, it may appear that the same action plan enacted in 2008 was used again during the pandemic. The same interest rate policy, dropping to near-zero rates, was applied in both 2008 and 2020/2021 with the same end goal – stimulate the economy by incentivizing spending. However, there are critical differences within the context surrounding the policy changes. Firstly, in 2008 inflation levels were at 5.6% which is higher compared to 2020/2021. Before the economic collapse in March 2020, inflation was sitting near 2%, the standard at which the Fed is comfortable per their mandate for maximum employment and price stability, but rates are climbing and in May of 2021 interest rates spiked to 5%. Unemployment was also a factor, the financial crisis brought on a longer period of job loss where unemployment was 5% in late 2007 and gradually increased to near 10% by mid-2009; unlike the quick spike in unemployment seen in 2020 where rates rose to 14.8% and quickly fell to 6.7% by end of year. Secondly, the Fed conducted the buybacks on the open market in 2021, meaning a surplus of money was being printed. This is unlike the QE that was used in 2008, where the Fed bought back securities at a smaller scale, increasing their overall balance sheet to ~$4.5T. Currently, QE has grown the

Fed's asset holdings to ~$8.1T. Finally, pandemic-related support packages from both the Trump and Biden administrations added trillions of dollars to consumers' income, contributing to inflation rates nearing 5% for 2021.

Inflation

Inflation represents increasing trends in prices of goods and services, as measured by the Consumer Price Index (CPI), the weighted average price of a basket of goods and services compared to a base. After the pandemic hit the globe, an economic downturn sparked unemployment rate and decreased consumer spending in 2020. Multiple stimulus packages have also been distributed as relief for lost income and to increase consumer spending. However, with businesses now reopening and jobs starting to come back, a high demand for goods and services is pushing prices up. Annual inflation in the U.S. has accelerated to 5% as of May 2021, marking the highest rate since 2008, with the CPI reaching $268.55. The largest price increases have been in used cars and trucks, utility gas service and gasoline, which are coming into high demand as stay-at-home orders are lifted. This forms the basis of a conclusion that the price change will be temporary and will reverse soon after the supply meets the demand, and thus is not cause for greater concern. According to Powell, the "inflation is expected to drop back toward our longer-run goal, and the median inflation projection falls from 3.4% this year to 2.1% next year and 2.2% in 2023." As long as inflation remains within the Fed's long-term goal of ~2%, interest rates will remain in the 0% to 0.25% range.

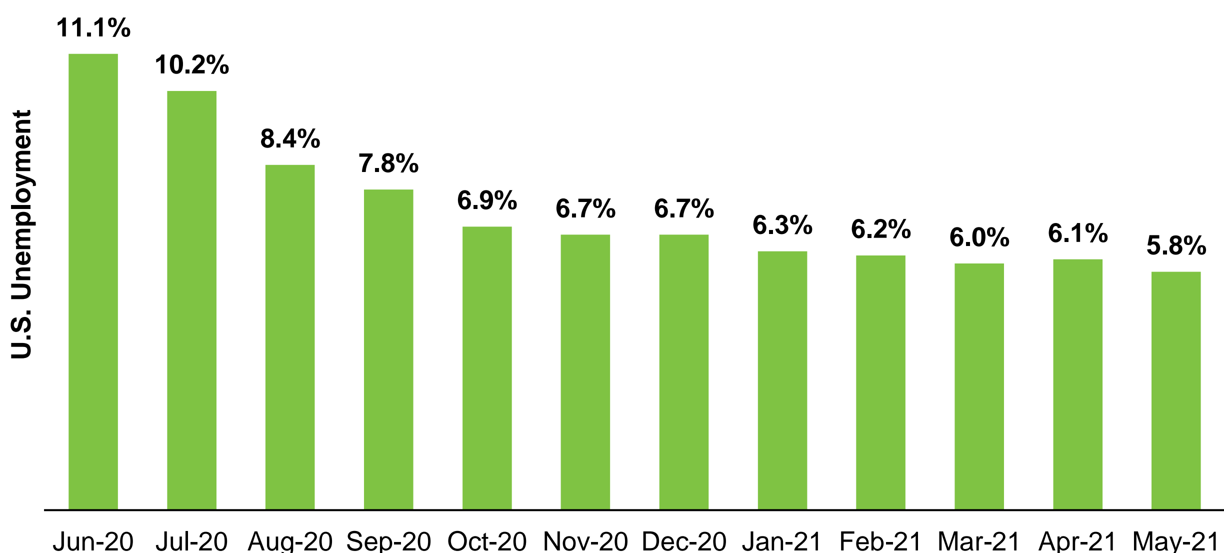
Exhibit 2: Inflation has steadily increased from a year ago at 0.6% to 5.0% as of May 2021



Unemployment Rate

The unemployment rate dropped to 5.8% in May 2021, marking the lowest unemployment rate since April 2020. The fast distribution of vaccines has promoted jobs to be added in the market. The total non-farm employment increased by 559,000 in May, with significant employment numbers increase in leisure and hospitality that contributed 292,000 positions. Despite the recovery from previous months, the current level of unemployment is still sitting 2.4 percentage points above the pre-pandemic level, with factors like unemployment insurance, fear of virus, and childcare contributing to lower job seeking. The Fed projects that the labor market will improve to 4.5% unemployment by the end of 2021 and 3.5% by the end of 2023. The combined effect of inflation and unemployment will limit consumer spending, and thus the Fed has stated it will not change the current interest rate until the unemployment rate has improved to the committee's assessment of maximum employment.

Exhibit 3: The unemployment rate is declining slowly, with May 2021 reaching the lowest point in a 14-month period



Housing Market – Supply and Demand

Movements in the housing market show some real impacts of how the inflation and low interest rate have influenced consumers. The demand for housing spiked during 2020, with the residential mortgage application rate increasing 24% as of October, driven by the low mortgage rate and work-from-home boom. However, the housing starts fell by 9.5% from the previous month in April, in reaction to the inflated price of the raw materials, with lumber prices reaching highs of $1,692 per thousand board feet in early May. Lumber prices have now declined to below $800, and housing starts have reacted accordingly, rising 3.6% in May. The overall trends in the price movement suggest a strong demand behind the underlying asset, but inflation and supply shortage also have affected the movement toward another direction.

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