Wall Street welcomes latest Fed decisions

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Financial markets have broadly welcomed the latest update on monetary policy from the US Federal Reserve following its two-day meeting this week, with stocks on Wall Street yesterday ending a four-day losing streak. The three major indexes all finished up by around 1 percent.

The main reason for the rise was the news that the Fed's tapering of its $120 billion monthly purchases will not be announced before its November meeting and will proceed at a relatively gradual pace until the middle of next year. The markets also drew comfort from Fed Chairman Jerome Powell's repeated insistence the test for an increase in the Fed's interest rate is higher than that for reducing asset purchases.

According to the interest rate projections by officials of the Federal Open Market Committee (FOMC), nine members expect an interest rate rise in 2022, up from seven in June, while the remaining nine expect the rise to be later.

The Fed has said it will not start easing back on asset purchases until there had been "substantial further progress" towards meeting its goals of average inflation of 2 percent and maximum employment.

Powell, who has sought to balance between members of the FOMC who want tapering to begin sooner and those in favour of holding off, said his own view was the "substantial further progress" test had been all but met and the Fed could "easily move ahead" with an announcement on the taper at its next meeting in November. There was broad agreement the asset purchases would be fully withdrawn around the middle of next year.

Commenting on the projections on interest rate rises by members of the FOMC, he said these did not represent a decision or a plan and that "more important than any forecast is the fact that policy will remain accommodative until we have reached our maximum-employment and price-stability goals."

Powell emphasised that the taper would take some months and "so you're going to be well away from satisfying the [interest rate] liftoff test when we begin the taper."

There were a series of questions at his press conference on the effect of the debt crisis of the Chinese property developer Evergrande, conflict of interest issues surrounding two members of the Fed and the dispute over the lifting of the US debt ceiling now before Congress.

Asked whether the Evergrande crisis was a "warning signal" for corporate debt in the US, Powell emphasised the importance of the massive Fed intervention in March 2020, at the start of the pandemic when the stock market crashed and the $21 trillion US Treasury note market froze.

He said the Fed was "very concerned" there could have been a "wave of defaults" but that did not happen because of the Cares Act and the response of the Fed – it injected some $4 trillion into financial markets. This was a "much stronger response then we've ever had" and as a result there were "very, very low" default rates for corporate debt.

He said there was not a lot of direct US exposure to Evergrande but there was a worry that it could affect global financial conditions through "confidence channels."

Powell was placed in the highly embarrassing position of having to answer several questions relating to conflicts of interest which have emerged following the revelation that two senior Fed officials, Robert Kaplan, the president of the Dallas Fed, and Boston Fed President Eric Rosengren, were actively trading in shares last year when the Fed was intervening to shore up markets.

The two have since said they will sell their shares by the end of the month after their activities were reported by the *Wall Street Journal* and Powell has ordered a review of its ethics guidelines.

Asked directly whether he had confidence in Kaplan and Rosengren, Powell avoided the question. In terms of confidence, he said no one on the FOMC was happy to be in this situation "to be having these questions raised" and it was "an important moment for the Fed."

But he was "reluctant to get ahead of the process and speculate" and when the Fed had things to announce it would go ahead "but that's really what I have for today."

The issue is significant in and of itself but also more broadly because it is yet another exposure of the Fed's carefully cultivated image that it acts in the interest of the American people and the economy rather than Wall Street.

With the debt ceiling issue now before the Senate, following a House of Representatives vote to lift it earlier this week, Powell was asked what would happen to the economy if it was not raised. Some 46 Republican senators have said they will not vote in favour, meaning there are not sufficient votes to defeat a filibuster, requiring 60 votes in the 100-member chamber.

Failure to raise the debt ceiling and ensure the government could pay its bills would result in "severe reactions, severe damage to the economy and to financial markets" and was not something "that we should contemplate," Powell said.

He insisted that "no one should assume that the Fed or anyone else can protect the markets or the economy in the event of a failure," and it was necessary to pay debts when they are due.

While the Fed meeting was taking place, two leaders of a US government advisory group, the Treasury Bond Advisory Group (TBAC), issued a letter to Treasury Secretary Janet Yellen on Tuesday warning of "severe consequences" if the ceiling were not lifted.

"If a protracted fight over the debt limit casts doubt on the creditworthiness of the US government or the timeliness of its debt payments, the Treasury markets would likely experience significant disruptions that could spark broader market stress," it said.

The letter, co-signed by TBAC co-chairs Beth Hammack of Goldman Sachs and Brian Sack of the DE Shaw group, said default would be "unthinkable, but even to risk that outcome would be reckless and irresponsible."

The debt ceiling issue is adding to the growing uncertainty surrounding the direction of the US economy. Despite the continued assurances from Fed Chair Powell that elevated inflation will abate in coming months, there are fears it is becoming entrenched. The Fed has also lowered its projections for economic expansion but continues to see rapid growth.

Like the lower inflation scenario, this assumption is also beginning to be questioned.

A Bloomberg report this week noted that with the winding back of stimulus measures that have supported the economy during the pandemic, growth could start to "slow sharply" in the second half of 2022, and this would be the case even if the Biden administration won congressional approval for its spending program.

According to Wendy Edelberg, director of the Brookings Institution's Hamilton Project, the US was "in for some very low growth rates" in late 2022 and 2023. Jan Hatzius, chief economist at Goldman Sachs, expects the US growth rate to be only 1.5 percent by the end of next year, down from 5.7 percent in 2021.

But the stock market is continuing to rise, and according to David Jones, director of global investment strategy for BofA Securities, this could create major problems.

"The longer this dissonance between the fundamentals and the positioning lasts, the more it raises the spectre of a violent, disorderly market event in which everyone is running for the door," he said.