US Outlook

Fed poised to taper amid inflation uncertainty

FOCUS

With risks of sustained inflation intensifying and signs of strengthening in final demand after a post-stimulus lull, conditions are in place for the FOMC officially to announce the taper plan signaled in September.

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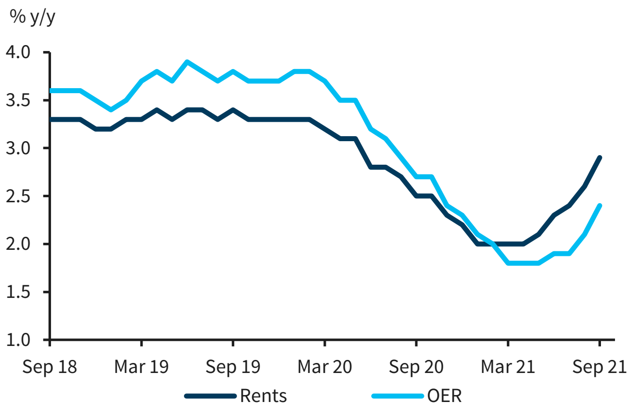
- This week's inflation data provided mixed signals about inflationary pressures, with significant firming of housing rents balanced against signs of incremental easing in supply constraints.
- Retail sales posted a second consecutive solid gain in September, suggesting that consumer spending is reaccelerating after having leveled off in the wake of March's stimulus bill.
- These influences put the FOMC on course for a taper announcement in November, with the September minutes discussing a plan for monthly reductions that cease purchases in mid-2022.

Incoming inflation data send mixed signals

This week's September CPI release continued to suggest that the most acute price pressures from supply bottlenecks are likely behind us, with headline CPI increasing 0.4% m/m (5.4% y/y) and core registering a modest 0.2% m/m (4.0% y/y) gain. These prints continue the noticeable deceleration that began this summer, after a series of robust monthly increases in core from April to June that ranged from 0.7% m/m to 0.9% m/m.

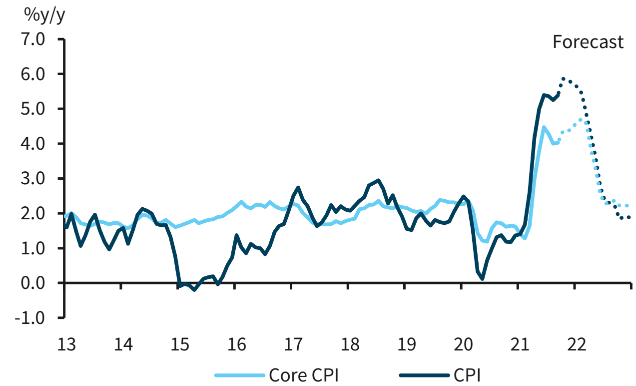
Although this deceleration is encouraging, the details suggest a much more nuanced picture. Some of the latest softening is likely due to another month of weakness in categories that are sensitive to infection risks - such as hotels and airline fares - which are poised to reverse course with new COVID-19 cases turning down again. Indeed, the weakness in these categories helped obscure strong gains in primary housing rents (+0.5% m/m) and OER (+0.4% m/m), which are firming after a sustained period of softness, despite skyrocketing house prices. At the same time, the latest producer price data point to incremental easing of supply bottlenecks, including a record 4.0% m/m decline in the index for transportation and warehousing services, which unwinds some of the nearly 15% run-up in this category from December to August. These signs are supported by other indicators, including encouraging developments regarding shipping costs and port backlogs that we noted in our CPI inflation preview.

FIGURE 1. Rents and OER have reaccelerated sharply after a sustained period of softness...



Source: BLS, Haver Analytics, Barclays Research

FIGURE 2. ...accentuating upside risks to the inflation outlook



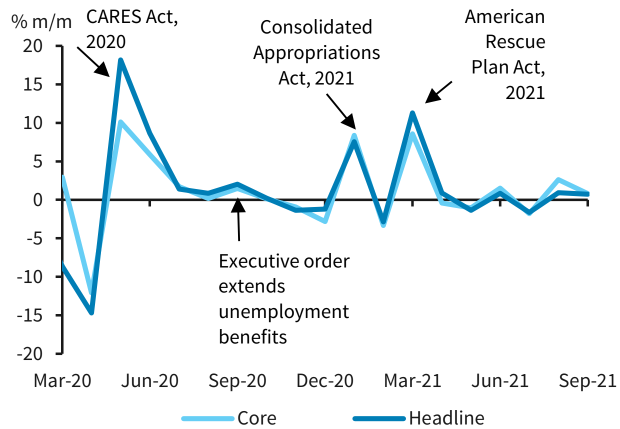
Source: BLS, Haver Analytics, Barclays Research

These crosscurrents highlight the continued volatility and uncertainty of the CPI outlook, which remains sensitive to supply chain issues tied to the course of the pandemic. Altogether, we expect the next several CPI prints to balance these various trends, with momentum in housing rents and expected firming in the prices of a number of pandemic-sensitive services (including airfares and hotels) weighing against incremental softening in goods prices as supply bottlenecks gradually improve. Reflecting this balance, our updated forecast has annual core CPI readings coming in at 4.5% y/y at end-2021 and 2.2% at end-2022. Nevertheless, we acknowledge that uncertainty about the inflation outlook remains unusually elevated, with persistent bottlenecks and other supply-side issues sustaining elevated price levels for many goods categories, and risks generally skewed to the upside.

September retail sales provide encouraging signals about final demand

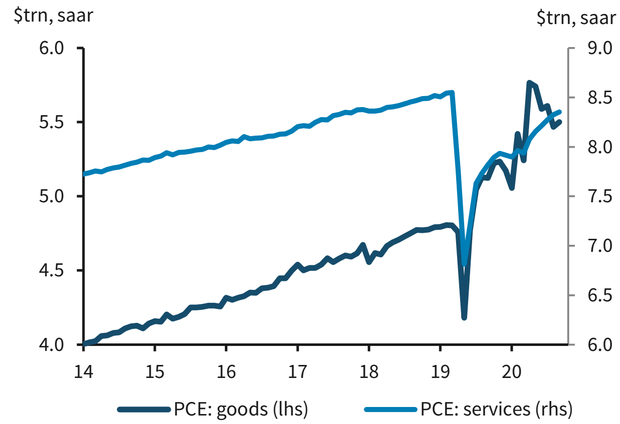
The September retail sales estimates provide some encouraging signals that the sharp deceleration in final sales indicated by our Q3 GDP tracker (now at 3.1% q/q saar) will not carry into Q4 21. Headline sales increased 0.7% m/m, and August's prints were revised higher, confirming that demand is finally regaining momentum following a soft patch in the wake of March's spectacular, stimulus-fueled increase of 11.3% m/m. September's gains were fueled by notable strength in a number of categories that are likely related to the resumption of in-person schooling, such as sporting goods, general merchandise, and apparel. Meanwhile, sales in the control category moved up 0.8% m/m following a 2.6% increase in August, while spending on food services posted a second-consecutive lackluster gain (0.2% m/m). While this composition, in itself, does not send particularly encouraging signals about the underlying trajectory of spending, our view is that income growth is more than sufficient to keep consumer spending on a solid trajectory in the coming months, with the rotation to services - particularly in the travel, recreation, and healthcare categories - likely to resume with Delta infection risks now abating.

FIGURE 3. **Fiscal income supports have distorted the trajectory of retail sales**



Source: Census Bureau, Haver Analytics

FIGURE 4. **PCE services remained well below its pre-pandemic trend in August**



Source: BEA, Haver Analytics

The taper discussion has become a taper plan

The September minutes reiterated the wide range of views across participants regarding the outlook, with little sign of consensus about the likely duration of supply bottlenecks and longer-term prospects for domestic labor supply. In our view, the fact that conditioning assumptions vary so widely across participants casts new light on the wide dispersion of rate projections in the September dot plot, with half the participants anticipating liftoff in 2022 and the cumulative number of hikes through 2024 ranging from as few as two to as many as ten. This is illustrative of the elevated uncertainties surrounding the inflation outlook, which will depend critically on the timeline for resolving global supply chain bottlenecks and whether longer-term inflation expectations remain well anchored as this process plays out.

Although a consensus on the outlook remains elusive in the face of ongoing uncertainties about inflation, the FOMC does appear to have converged on a plan to manage these risks. Indeed, the September minutes make it clear that there is broad agreement that the bar for achieving “substantial further progress” is very low, and we think that this test was likely surpassed by the moderate progress in last week’s September employment numbers. In our view, a November tapering announcement is part of a risk management strategy that took root as prices surged last spring, designed to put the FOMC in a position to initiate a rate hike cycle in mid-2022 (or perhaps even earlier) if upside risks to the inflation outlook materialize. The minutes clarify other elements of this strategy, which, broadly speaking, is designed to preserve flexibility regarding the pace and initiation date. Specifically, the minutes signal that tapering would occur in monthly increments of $10bn/m (Treasuries) and $5bn/m (MBS), which would end the timeline in after seven months, with the committee reserving the right to adjust the pace as economic conditions warrant. The minutes also signal that, following an announcement at the November meeting, the tapering process could begin in either mid-November or mid-December. With another encounter with the debt ceiling in early December looking like a distinct possibility as Congress continues to wrangle over the budget, this latter option may allow the committee more scope to manage risks.

US Q3 GDP TRACKING AT 3.1%

Pooja Sriram, BCI, US

The GDP tracker was unchanged this week, at 3.1% q/q saar. Elements of CPI and PPI data, used as deflators in our tracking models, were largely in line with expectations and had no material effect on the tracker. Core retail sales through September were only marginally higher than we had penciled in, leaving our Q3 PCE and GDP tracking estimates unchanged. Similarly, import prices and business inventories data led to only minor revisions to the various GDP components, leaving the headline tracking estimate at 3.1%, after rounding.

FIGURE 5. The effect of incoming data on our GDP tracking model

		Details of Q3 2021 GDP tracking estimate (% q/q saar, unless indicated)											
Date	Data release	GDP	Final sales	PCE	Res. inv.	Equip	Struct	IPP	Gov	Exports	Imports	Net exports (level)	CIPI (level)
8-Oct	Wholesale inventories	3.1	0.6	1.3	-7.0	-8.0	-3.9	5.0	2.3	0.4	4.6	-1282.7	-14.8
14-Oct	CPI & PPI	3.1	0.7	1.3	**-6.5**	-8.0	**-3.5**	5.0	2.3	**0.5**	**4.7**	-1282.7	**-14.3**
15-Oct	Retail sales	3.1	0.7	1.3	-6.5	-8.0	-3.5	5.0	2.3	0.5	4.7	-1282.7	-14.3
15-Oct	Import prices & business inventories	3.1	0.7	1.3	-6.5	-8.0	-3.5	5.0	2.3	1.4	5.5	**-1284.6**	**-13.8**
Current quarter tracking		**3.1**	**0.7**	**1.3**	**-6.5**	**-8.0**	**-3.5**	**5.0**	**2.3**	**1.4**	**5.5**	**-1284.6**	**-13.8**
	Contribution to GDP growth (pp)		*0.7*	*0.9*	*-0.3*	*-0.5*	*-0.1*	*0.3*	*0.4*			*-0.7*	*3.1*
Barclays official forecast		**3.0**	**0.8**	**1.5**	**-7.0**	**-8.0**	**-4.0**	**5.0**	**2.5**	**0.5**	**4.5**	**-1280.9**	**-28.5**

Note: Our GDP tracking estimate is distinct from our official published GDP forecast. It reflects the mechanical aggregation of monthly activity data that feed directly into the BEA's GDP calculation. Where data releases have implications for the tracking components, cells have been bolded.
Source: Barclays Research