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ECONOMIC TALKING POINTS

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The Fed prepares for a delicate two-step dance: Taper and Tightening

We begin with at least one certainty. The Fed tomorrow will announce plans to greatly accelerate the timing to terminate QE. Anything less than a full doubling in reductions of purchases in treasuries and MBS, that is from $15 billion to at least $30 billion a month, would not be viewed kindly by the financial markets.

Assuming the decision is formally made to hasten the pace of tapering, it would mean QE should finally come to an end by next March

What happens next, however, will be of greater consequence.

Many analysts have already bid up their predictions of Fed rate cuts to two, three or even more hikes in 2022. I suspect tomorrow's dot plot will reflect much the same range.

The urgency to tighten monetary policy is understandable given the 6.8% spike in November's annualized consumer prices, followed by this morning's eye-popping 9.6% surge in producer prices for final demand.

These are deeply uncomfortable markers for Fed policymakers, to the point where one can almost sense their exasperation. After all, we're now nearly two years into this Covid shock. Yet new variants continue to sneak out of frontier economies because more than 90% of the population some of these countries have yet to receive even a single shot.

At the same time, the global supply chain still seems mostly tied up in knots. There has been some easing lately but the progress has been maddeningly slow.

The fear now is this: Strong consumer demand will thus continue to bump up against limited supply and that translates into even higher prices next year. At least, that is the current perception.

As a result, the Fed is gearing up for some white-knuckle months ahead! The pandemic has metamorphosed into an endemic, and by definition that means this virus and its variants could still wreak havoc well into 2022

That's why deep in the labyrinth of the Federal Reserve, economists will have to confront several difficult questions:

1. Does the Fed have a good grasp in understanding the inflation dynamics inside an economy that's still under siege from a prolonged exogenous shock?

2. Will passage of a trillion dollar plus Build Back Better plan ease --- or aggravate inflation pressures?

3. Are forces now in play that could ignite a wage- price spiral that will be difficult to contain?

And that's not all. Come next March, the most immediate issue facing the Fed is how treasury yields will respond now that a major buyer of US debt is out of the picture?

If the Fed's absence is so palpable that it rapidly drives the yield on the10-year treasury benchmark towards 2% and beyond, then that move alone might be enough to cool economic activity and thus lessen the need for the Fed to aggressively hike the fed funds rate. Of course, if the reverse is true and yields on notes and bonds remain where they are, or even drop, the central bank has a green light to hit the monetary brakes harder.

The second issue at the end of Q1 is whether inflation is showing signs of turning down? Will there be evidence of an inflection point? There is a decent case to be made that prices could well begin its descent by then.

• More people in the US will be fully vaccinated and choose to rejoin the labor force. Any increase in the supply of labor will ease wage pressures and help increase production.

• Energy prices may retreat as well with winter's end, especially if both OPEC Plus and US producers ramp up production. (The Baker Hughes US oil rig count has been climbing all year as shale oil producers in the Permian and Eagle Ford basins see opportunities with crude at about $30 bbl. above their breakeven.)

• And third, it is not at all improbable to see an improvement in supply chain logistics by the IIQ, which will also help dampen inflation pressures. This morning

we got a read on November's Cass Freight Index and it showed the flow of goods in the economy continuing to improve.

So, while the term "transitory" is now verboten in the Fed's lexicon, our projection does have inflation cresting by 2Q 2022 and then "transitioning" to 3.5% by the end of year.

Even if all the three positive developments above materialize, that will still not dissuade the Fed from proceeding with a lift-off in rates next spring. The chorus of complaints claiming Powell is already behind the curve has gotten louder and ---- despite all his past utterances of being solely data dependent--- those public warnings do have an effect.

So we expect to see two 25 basis point rate hikes next year, with the fed funds settling between 50 to 75 bp by the IVQ. The Powell/Brainard team will then gently follow up with additional increases in 2023 as the economy continues to improve and edges closer to full employment. By the way, the metric on the latter is not the unemployment rate, but rather the gap between job openings and the number of unemployed actively looking for work. That gulf is turning out to be a better gauge of future underlying wage pressures.

The stage for 2022 has been cleared for the Fed to commence a delicate two-step dance. For they know the margin of error is very slim. This pandemic was a shock far beyond the bounds of any conventional economic model. Thus any stumble or miscalculation with regards to monetary policy can slow this economy's recovery, or something worse.

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United States

	I 2020	II 2020	III 2020	IV 2020	I 2021	II 2021	III 2021	IV 2021	I 2022	II 2022	III 2022	IV 2022	I 2023	II 2023	III 2023	IV 2023
Real Gross Domestic Product (GDP):																
%	-5.0	--31.4	33.4	4.3	6.3	6.7	2.1	6.6	3.1	3.4	3.1	2.9	1.8	2.7	2.5	2.6
Personal Consumption Expenditures:																
PCE %	-6.9	-33.2	41.0	2.3	11.4	12.0	1.7	7.1	2.6	4.2	3.7	2.9	1.5	2.9	2.8	2.7
Inflation, end of period, year-over-year:																
CPI %	1.5	0.6	1.4	1.4	2.6	5.3	5.4	6.9	6.8	6.1	5.5	3.8	3.3	2.8	2.6	2.3
Unemployment Rate (end of period):																
%	4.4	11.1	7.8	6.7	6.0	5.9	4.8	4.1	4.1	4.2	3.9	3.8	3.9	3.7	3.6	3.5
Non-farm Payrolls, monthly avg. thousand:																
	-303	-4,427	1,322	213	513	615	651	465	455	625	865	640	385	510	495	480
Treasury 10-yr Note Yield % (end of period):																
	0.63	0.65	0.68	0.91	1.75	1.44	1.52	1.48	1.60	1.65	1.75	2.05	2.10	2.10	2.26	2.35
Federal funds rate % (end of period):																
	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.38	0.63	0.88	1.13	1.38	1.63

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
US	2.6	1.6	2.2	1.8	2.5	3.1	1.7	2.3	3.0	2.2	-3.5	5.4	3.3	2.6
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.9	1.2	-6.7	4.0	3.5	2.2
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.3	1.5	-9.8	5.9	4.8	2.9
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	2.2	0.3	0.7	-4.8	2.4	2.8	2.2
Canada	3.1	3.1	1.8	2.3	2.9	0.7	1.0	3.2	2.0	1.6	-5.3	5.2	4.7	2.7
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	4.8	-8.2	6.9	7.3	6.7
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	6.1	2.3	6.6	5.9	5.6
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.1	-4.4	4.9	2.1	2.4
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.1	-0.1	-8.4	5.9	2.8	2.7
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.8	-1.1	4.8	3.1	2.3
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	1.2	-2.9	3.8	2.9	2.4
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.9	--3.8	5.6	4.8	3.6

Key Economic & Geopolitical Projections for 2021 & 2022

- Updated: December 6, 2021

PROBABILITY	U.S.
Moderate	Federal Reserve will accelerate schedule to reduce asset purchases, and terminate QE by 2Q 2022.
HIGH	Inflation (CPI) to drop back to 3% range late 2022 as supply chains logistics improve and oil falls to low $60s.
HIGH	Federal Reserve seen raising fed funds rate twice in 2022, first (25 bp)in 2Q 2022 and again in final quarter.
Moderate	Treasury 10-yr. yields to hover between 1.60% to 2.00% in 2022, and surpass 2% in 2023.
HIGH	Covid-19 becomes an endemic. Low vaccination rates in Africa & parts of Asia remain breeding grounds for new variants.
Moderate	Congress to pass a more modest ($1.5 trillion) "Build, Back Better" plan by 1Q 2022, with modest change in tax rates.
	FOREIGN
HIGH	China's economy to sharply decelerate due to shakeout in property market, broad deleveraging & fresh Covid outbreaks.
HIGH	Beijing fortifies naval presence in SCS and ramps up threats against Taiwan.
HIGH	Biden orders greater US naval presence in SCS to defend International Law of the Sea and support regional allies.
HIGH	US - Russian tensions approach cold war levels over Moscow's cyberattacks and its actions to destabilize Ukraine.
Moderate	A cyber World War is underway; could result in disruptions to global financial networks and power grids.
HIGH	Iran's new hard-line president secretly backs policy to produce enough fissile material for a nuclear weapon.
Moderate	Economies of US & Europe to steadily improve in 2022, but recoveries in Africa & South America to lag behind 1 - 3 years.