

Jackson Hole – A Non-Event

Investment Team Weekly Focus

31 August 2021



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Jackson Hole Symposium (27 August 2021)

Federal Reserve Chair Jerome Powell said the U.S. central bank could begin slowing down asset purchases this year as the U.S. economy recovers from the pandemic, but it won't be in a hurry to raise interest rates

Why?

- Wants to be sure of any disruptions in the economic activity caused by the Delta variant.
- Wants substantial progress to full employment, including labor participation being well distributed and unemployment rate going further down (lowest was 3.5% pre pandemic vs 5.4% currently)
- Fed views that current inflation is caused by supply chain disruptions and will eventually normalize, or in other words, thinks inflation is transitory.
- The present value of the Fed's outstanding debt will be reduced as it gets discounted by the inflation rate, hence a low interest rate and moderate inflation benefits the Fed in reducing its debt burden. The US has \$30trn of debt with an interest cost of approx. \$523 billion (**in 2020 as per Congressional Budget Office www.cbo.gov**). The total Fed budget is \$3.5 trn. With such numbers, it will be increasingly difficult for the Fed to reduce its debt burden.



No reaction

- 10Y UST fell to 1.33% from 1.35% reflecting that the Powell's statement was in line with the expectations.
- Inflation expectations have also been stable as can be seen from the 5Y US Breakeven Index.

10Y UST Yield Curve



5Y US Breakeven Index



Source: Bloomberg, Lighthouse Canton

Credit Spreads

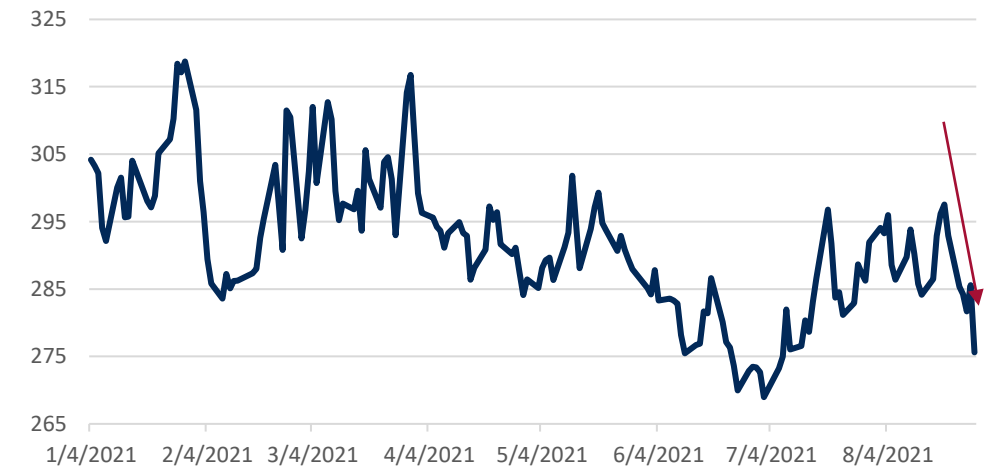
Spreads fell in both high grade and HY space

- The Markit CDX North America Investment Grade Index is composed of 125 equally weighted credit default swaps on investment grade entities, distributed among 6 sub-indices: High Volatility, Consumer, Energy, Financial, Industrial, and Technology, Media & Tele-communications. (Top Chart)
- Markit CDX North America High Yield Index is composed of 100 non-investment grade entities, distributed among 2 sub-indices: B, BB. All entities are domiciled in North America. (Bottom Chart)
- **The reduction in CDS (credit default swaps) spreads means that bond prices most likely will rise further in near future.**

CDX IG 5Y Spread



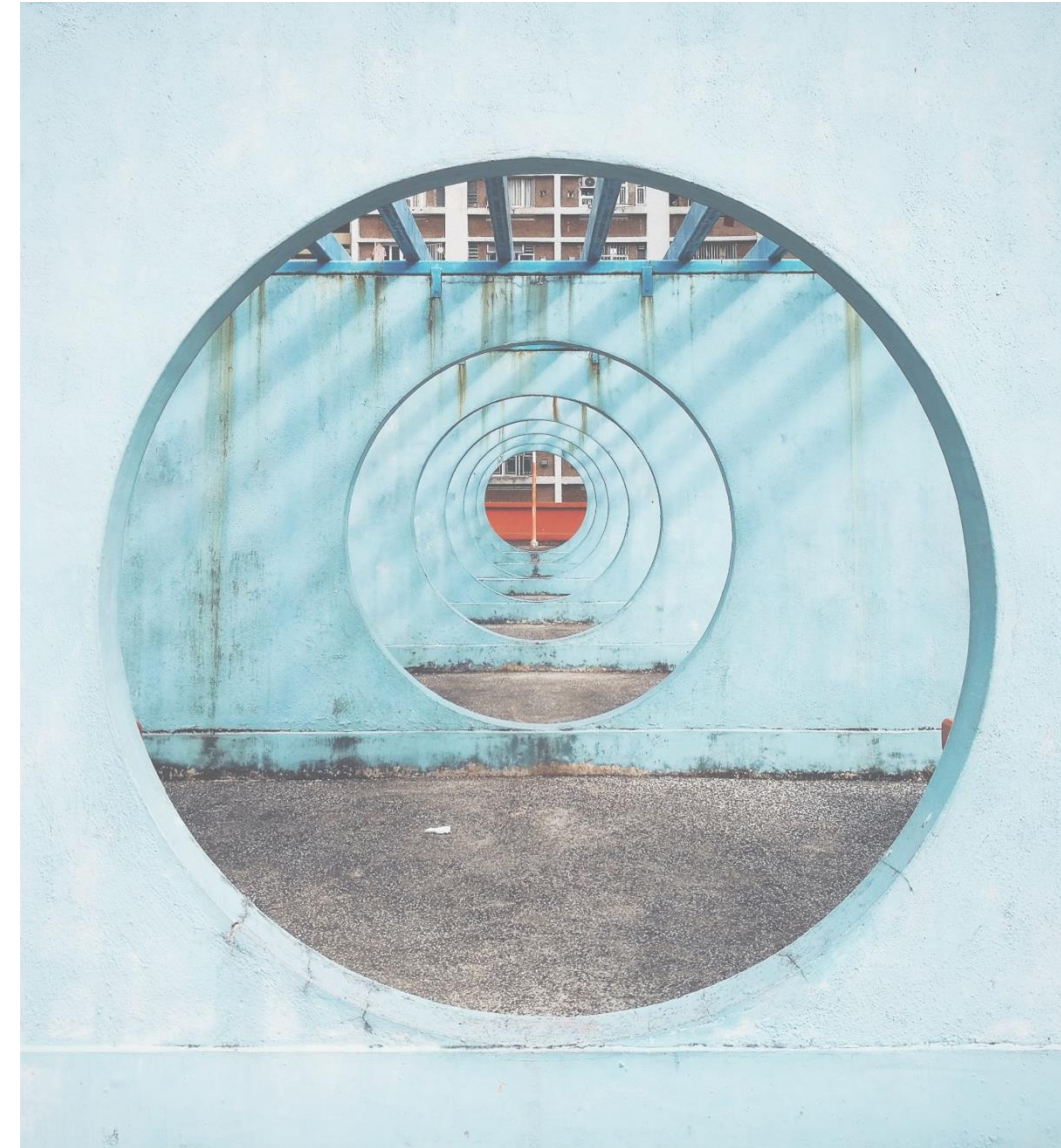
CDX HY 5Y Spread



Source: Bloomberg, Lighthouse Canton

What's next on Tapering and its possible effects?

- Powell didn't provide a specific timeline to start scaling back the Fed's \$120 billion-per-month in bond buying, a program started last year in response to the Covid-19 crisis. While the economy is on a strong path forward, the Fed will be carefully assessing incoming data to see how risks like the Delta variant of the virus might impact progress toward its goals, Powell said.
- Consensus expectations are clear information to be provided at the FOMC(Federal Open Market Committee) to be held on 21 - 22 September 2021, tapering to be announced at the following FOMC on 2 - 3 November 2021, and the reduction in bond purchases starting in Dec 2021
- Assuming the above timeline is adhered to, and the first interest rate hike is not sooner than expected (currently expected to be in 2023), then the impact on the markets- bonds and equities alike, is likely to be muted.
- The bottom line for markets is clear communication from the Fed and if it is clear and as anticipated, the markets will take the decisions in their stride.
- **Risks to the above could be stronger than anticipated inflation print (most likely owing to increase in rentals/ Core PCE) and/or larger strides towards full employment. Both will most likely force the Fed to change its dovish stance.**
- **To conclude, the release of economic data on Housing, PMIs (Purchasing Managers Index), Jobless Claims and Non-Farm Payrolls this week will determine the outcome of the FOMC in September.**





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