CIO OFFICE MORNING MARKET WRAP – 23rd September, 2021. ALSO AVAILABLE ON ALEXA.

Asian stocks are rising this morning after US shares digested the prospect of the reduction in US stimulus already in November and some concerns on property developer Evergrande eased. The mainland China and Hong Kong markets rallied, including shares of the indebted property developer. The PBOC made large liquidity injections, reducing systemic stress, while media reported the possibility of a state-led restructuring for Evergrande. US stocks gained 1% and surged to session highs yesterday to fade back following the conclusion of the FOMC meeting, Treasuries were stronger alongside the US dollar, while gold reversed initial gains.

At the September meeting the Fed paved the way for the announcement of the tapering of asset purchases in November, that "may soon be warranted" as per the official statement and showed a more hawkish projection of future policy rates than the market expected via the so-called dot plot. The FOMC seems eager to end asset purchases pretty soon, with "a tapering process that concludes towards the middle of next year", implying a steep reduction of purchases of $15bn per month. Inflation forecasts were revised sharply higher, especially for 2021, while growth projections were downgraded for 2021 but bumped higher for 2022. The big surprise was that half of Fed officials were in favor of a first-rate hike by the end of 2022, followed by three more both in 2023 and 2024. Overall, the impression is of an increased FOMC concern about inflation, hence the shorter tapering process leaving room for earlier tightening if need be. Is Average Inflation Targeting already been thrown to the wind? Price action anyway suggests that markets remain unconvinced about the Fed's ability to raise rates as per its longer-run projections, and actually long-dated yields dropped causing a flattening of the curve. Considering the 1-month Overnight Index Swap rate 5 years ahead as per forward pricing as a proxy for the Fed's terminal rate, the market currently sees that rate at 1.4%, rather than 2.5% where it should be according to the dot-plot. It should come as no surprise if the Fed changes course along the way.

Two issues are now at stake in US politics and must be urgently dealt with by Congress, the funding of the government for the new fiscal year starting October 1 and the raising of the debt ceiling. The former is achieved when a budget for the fiscal year is approved, failing which a government shutdown would occur, while the latter means that without the raising of that ceiling past obligations of the US government would not be met. A government shutdown is an event investors have already seen multiple times and barely leaves a mark on the economy, while a default on existing debt, even for a short period of time, would precipitate a crisis and see Treasury yields spike. Tuesday evening the Democratic-controlled House passed a bill which conflates the two issues, a bill that would suspend the debt ceiling into December 2022 and also provide funding for the government to operate past September 30. There is a problem with this: Republicans refuse to approve any debt-limit measure since Democrats intend to approve the $3.5tn tax and social spending bill using the so-called reconciliation process, that would not require Republican support. The crux of the matter is that the more polarised positions become, the higher the risk of last-minute agreements spurring market volatility. The US government should be able to pay its obligations till sometime in the last week of October before the ceiling is breached. Powell himself felt the urge to remark during the press conference that a default would do 'severe damage' to the economy.

The OECD hiked the inflation outlook for most developed economies, and in particular the US, the UK and the Eurozone for 2021 and 2022, the first supranational institution to take stock of the so-far anecdotal evidence in favor of a not-so-transitory inflation view. Forecasts for inflation were raised for the US to 3.6% for 2021 and 3.1% for 2022 and for the euro area to 2.1% for 2021 and 1.9% for 2022. In spite of Jay Powell's poise, according to the OECD it was a "difficult balancing" act for central banks to manage the risk of price growth getting out of control. The OECD sees price pressures peaking not before year-end, and gradually easing in 2022, and considers important that higher prices do not consolidate an inflationary mindset. It is anyway very hard to reconcile the OECD unease with higher inflation transpiring from its September interim report and the warning it issued that governments should avoid over-hasty withdrawal of stimulus to support growth. After all, the proverb says that you can't have your cake and eat it.

Stay safe.

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