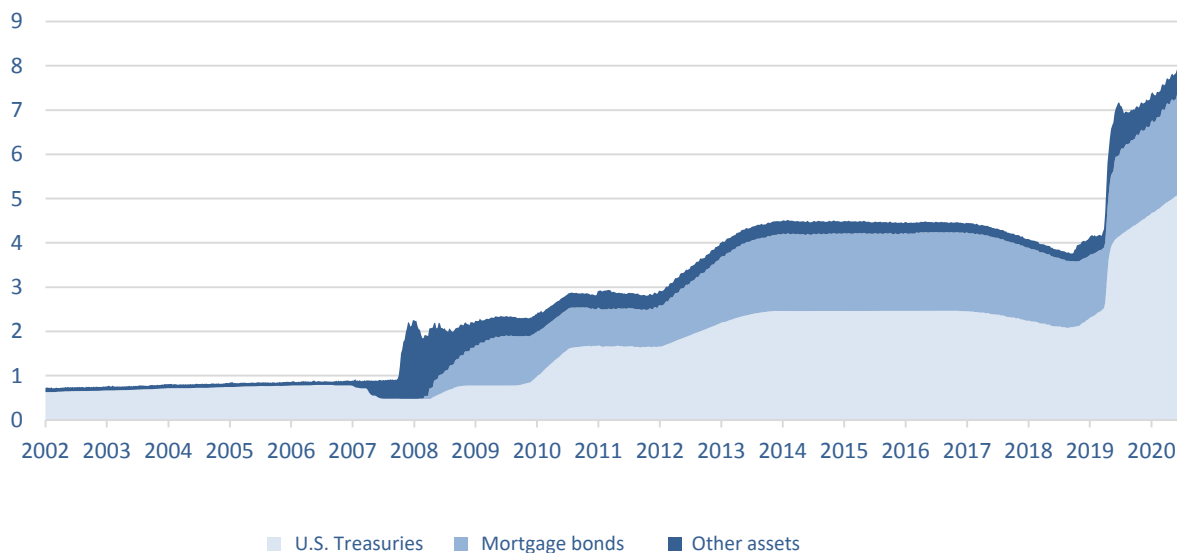


Macroeconomic review: Federal Reserve's policy implications

Since early 2020, Federal Reserve has pursued Quantitative Easing (QE) policy, that is, it purchases mortgage bonds and Government bonds expanding its balance sheet. Federal Reserve's policy has critical influence today on equity markets, for the following reasons:

- First, Federal Reserve's assets have grown by as much as \$3.8 trillion in the course of QE — more than 15% of U.S. GDP. A very significant figure for stock markets.
- Second, Federal Reserve is setting trends for other Central Banks. Since the onset of COVID-19 pandemic, all regulators emitted altogether \$10 trillion, or more than 10% of global GDP, during the year 2020. *If Federal Reserve starts slowing down QE rates, other regulators will follow this trend, which may lead to very significant stock index drops.*

Federal Reserve's assets, \$ trillion



Source: Board of Governors

Federal Open Market Committee (FOMC) meeting ended Wednesday night. Updated press release published after the meeting emphasized quick recovery of the U.S. economy rather than concerns about massive losses incurred during COVID-19 pandemic.

Similar trends can be observed in forecast by FOMC members: GDP forecast for 2021 was improved by 0.5 percentage points.

Federal Reserve's forecasts at June and March meetings

| | Latest (June 16) | Previous (March 17) |
|----------------------------|---------------------|------------------------|
| GDP growth (2021) | 7.0% | 6.5% |
| Inflation (2021) | 3.4% | 2.4% |
| Unemployment (2021) | 4.5% | 4.5% |
| Key rate (2021) | 0.1% | 0.1% |
| Key rate (2022) | 0.1% | 0.1% |
| Key rate (2023) | 0.6% | 0.1% |

Source: Federal Reserve Board

Of special concern were 2 facts in the forecast:

- Inflation forecast growth by as much as 1 percentage point.
- Expectation that the rate would be increased twice by the end of 2023, as compared to March forecast where no increase was expected at all.

FOMC members see that U.S. inflation may turn out to be not transitory in nature, and that the U.S. economy is recovering quickly enough, which gives rise to stimulus reduction.

U.S. inflation is the biggest risk point. The higher it is, the earlier FRS will slow down QE rates. There are 3 major factors of U.S. Inflation growth now:

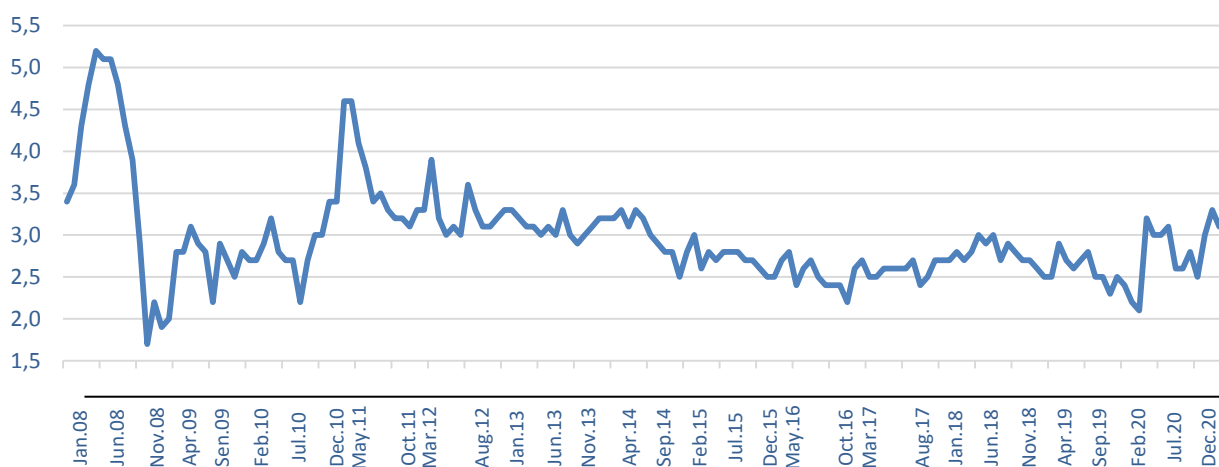
1. Deferred demand due to the ease of restrictions in the United States.
2. Supply chain disruptions and inability to cover demand with supply.
3. Growth of global commodity prices because of introduction of liquidity to stock markets in the course of QE by Central Banks.

All these 3 factors are transitory. However, there is a risk that Americans' inflation expectations will increase because of (though transitory) inflation growth. If consumers anticipate a rise in prices, they will buy more, and manufacturers will increase prices, causing inflation expectations to increase, and so on. A temporary price increase can grow into inflationary spiral in the United States.

It is exactly long-term inflation factors that Federal Reserve is concerned about now, that is, inflation expectations. They reached 3.4% in April, a record high since 2011.

Conclusion. It is exactly inflation expectations that should be traced to determine when stimulus wrapping-up will start, and what the extent will be.

Consumer inflation expectations, %



Source: University of Michigan

Inflation expectations have not yet reached such an 'unacceptable' level where Federal Reserve would wrap up QE program quickly. We see 3 scenarios to be followed by Federal Reserve:

1. Baseline (65% probability).

Federal Reserve announces in August that it will slow down QE rates less than 2 times starting from this fall.

2. Positive (15% probability).

Inflation begins to decrease starting from June, and Federal Reserve postpones QE reduction discussions till fall or winter.

3. Negative (20% probability)

Americans' inflation expectations exceed 4%–4.5% in May or June. In this case, our expectation is that Federal Reserve will have to cut QE more than 2 times before late summer or early fall.

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