Investment Event

27 January 2022
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Fed moving from reactive to proactive

At the January meeting, the Federal Reserve (Fed) maintained the federal funds target range at 0.00-0.25%

The statement noted that it will soon be appropriate for the Fed to raise the policy rate

The FOMC is discussing how and when to run down the balance sheet. Chair Powell suggested it will happen earlier and more quickly than in the previous cycle

Our views

With the economy in an expansion phase and the Fed on the cusp of starting to remove policy accommodation yields have the potential to rise further

The potential for higher yields means we are also selective in our exposure to risk assets

A March rate hike is on the cards

At its January meeting, the Federal Open Market Committee (FOMC) of the US Federal Reserve (Fed) left the target range for the federal funds rate at 0.00-0.25%, as widely expected. It also opted to maintain the pace of tapering it set out at the December policy meeting, meaning net asset purchases are still expected to end in early March.

While policy was left unchanged this month, the accompanying statement noted that “the Committee expects it will soon be appropriate to raise the target range for the federal funds rate”. This effectively tees up 25bp hike at the March meeting, something that Chair Powell confirmed was likely, so long as the economy behaved broadly as expected in the interim period. More generally, Chair Powell struck a hawkish tone at the press conference and, combined with the release of an additional statement on the principles for reducing the size of the Fed’s balance sheet, this moved markets.

From QE to QT

Chair Powell’s relatively hawkish tone reflected the Fed’s confidence that the labour market is in a strong place despite the shortfall in jobs relative to pre-Covid levels and its concern that inflation may not decline as quickly as set out in its December economic projections. On the latter, Chair Powell said in his opinion the outlook for inflation was a “bit worse” and that he would be inclined to revise up his own estimate for end-2022 core PCE inflation by “a few tenths”. On the labour market, Chair Powell emphasised various business and consumer surveys showed the labour market was tight while wage growth has risen “briskly”.

The statement on balance sheet normalisation was high level with the details on issues such as the timing, the pace of reduction and terminal size of the balance sheet yet to be fully discussed by the Committee. Again, however, the press conference provided some further insights. In particular, Chair Powell noted that:

- The details would be discussed in upcoming meetings – specifically March and “at least one other”. This would suggest the earliest that the plan would be published is May.
- The balance sheet is larger than when the Fed last embarked on quantitative tightening (QT), the economy is stronger and inflation is higher. Normalisation would, therefore, be likely to start earlier in cycle and proceed at a faster pace.

Macro and investment implications

Market expectations for Fed policy had moved a long way since the final months of 2021 and, heading into the January meeting, four 25bp hikes were more or less fully priced in for 2022. Nonetheless, at the time of writing, the tone of the press conference had pushed market to price in a material chance of five rate hikes over the coming year. In turn, this pushed 2y and 10y UST yields up by around 14bp and 10bp respectively.

Looking ahead, yields have the potential to rise further as the economy expands and the Fed removes policy accommodation. The upside to nominal Treasury yields is more likely to arise from the real, inflation-adjusted, component. While this “real” yield has risen notable from -110bp in late December to -55bp at the time of writing, this is still well below perceived equilibrium levels and will be hard to sustain as monetary policy is tightened.

The potential for higher bond yields suggests a cautious and selective approach to risk assets is sensible given the current subdued level of expected returns following a strong performance in 2021. Higher rates in the context of a still-decent macro backdrop (the US economy is set to expand at an above-trend pace and inflation is likely to moderate from Q2) favours the value factor over growth factor.

For the USD, solid growth and declining inflation would normally be consistent with some USD weakness, but this needs to be set against rising yields and the potential for volatility, both of which are USD supportive. Overall, we are neutral on the USD, which, despite strengthening after the Fed meeting, is still below its recent November high on a DXY basis.

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