FLASH: 27 JANUARY 2022

Fed: unnecessary panic after the FOMC meeting

Summary

- The statement of the FOMC meeting held yesterday did not contain any meaningful surprise but Fed chair Powell sounded quite hawkish during the press conference. Hence, markets reacted nervously.
- The Fed is set to normalise its monetary policy using, at the same time, a classic tool i.e. interest rate hikes, and the balance sheet tool, with a gradual decrease in reinvestment of maturing assets, to let its balance sheet naturally shrink.
- We think that chair Powell is talking tough given that inflation is too high and has become a political issue. However, we believe that inflation will decline in the course of the year, allowing the Fed not to be forced to hike rates at every meeting. We stick to the view of 4 rate hikes in 2022, of 25bps each at every quarter, starting in March.
- The Fed seems to want to start the balance sheet reduction sooner rather than later. An announcement looks now more likely to come in June for a July start, one month earlier than we had previously thought.

The statement of the FOMC meeting held yesterday did not contain any meaningful surprise

The US economy is on a strong footing and the labour market has recovered rapidly. The Fed has achieved its maximum employment goal according to some metrics. Inflation is high, too high.

Thus, the economy can withstand a fair amount of tightening. The Fed will end its asset purchases in early March as planned and then start tightening its monetary policy, with rate hikes and balance sheet reduction after rate hikes commence.

but Fed chair Powell sounded quite hawkish during the press conference

Powell did not rule out a rate hike at every meeting, nor did he rule out a 50bps rate hike in March.

On the balance sheet, he said that there is a substantial amount of shrinkage in the balance sheet to be done and softened the blow by adding that the process will be orderly and predictable.

There are still a lot of uncertainties and Powell admitted that the Fed will need to be nimble. The Fed wants to keep its options open over the timing, magnitude and pace of monetary tightening.

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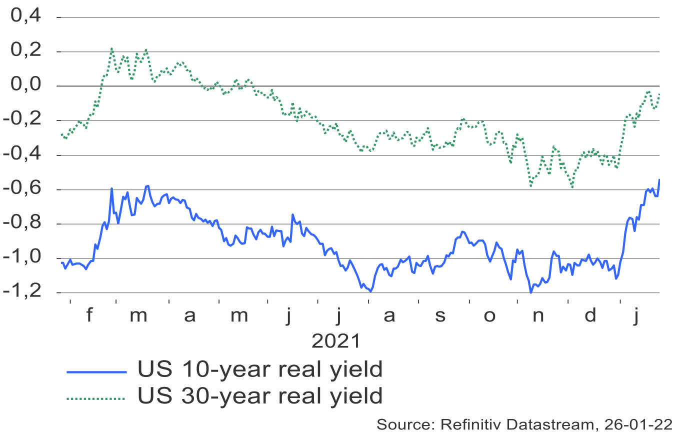
Initial markets reaction

Markets reacted to the hawkish press conference. Equities dropped 3.5% intraday. The US 2-year yield surged to the highest level since the start of the pandemic and long-term yields rose as well, especially real yields. Bond markets increased their expectations to 4.5 rate hikes in 2022.

US LONG TERM REAL YIELDS HAVE BEEN SURGING



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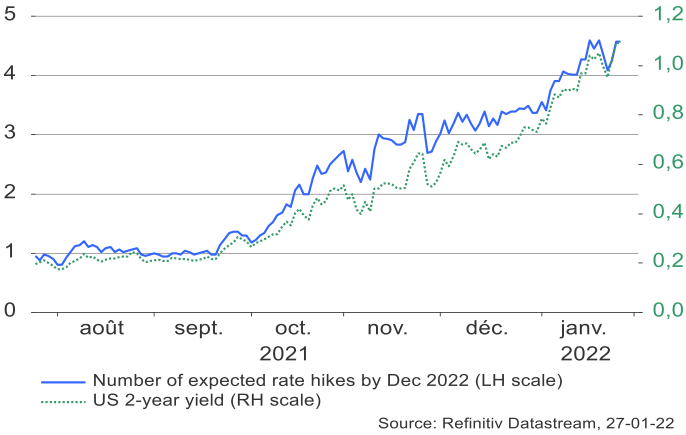
US SHORT-TERM YIELDS ARE RISING ALONG HIGHER MARKET'S EXPECTATIONS OF FED INTEREST RATE HIKES



Source: BNP Paribas Wealth Management

Our take on the rates

We exclude a 50bps rate hike in light of Governor Waller's recent comments that the Fed do not want to surprise markets.

We think that the Fed is talking tough given that inflation is too high and has become a political issue. As politicians told Powell at its Testimony before Congress, inflation is a tax on citizens, particularly on low-income citizens. Inflation is not yet at its inflexion point, so the Fed needs to convince the market that it is willing to do more to curb inflation.

However, we believe that inflation will decline over the course of the year, allowing the Fed not to be forced to hike rates at every meeting (there are seven meetings left). We keep our assumption of 4 rate hikes of 25bps each this year, with the first one coming in March. The risk remains that the Fed could do more as inflation risks are currently still to the upside.

Our take on the balance sheet reduction

Chair Powell made clear the Committee has not yet had discussions on details regarding the balance sheet reduction (Quantitative Tightening, QT), and that it would likely take at least two more meetings to do so.

Still, the move suggests the Fed wants to start QT sooner rather than later. An announcement on QT now looks more likely to come in June for a July start, one month earlier than we had previously thought.

QT will be achieved via caps on reinvestments, like in the previous experience in 2018, allowing the balance sheet to decline smoothly and in a predictive manner. The Fed does not seem to envisage outright sales of assets.

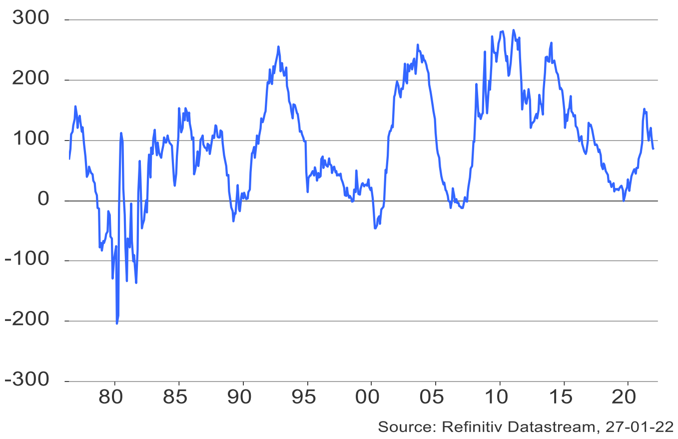
Some indicators we monitor

The level of inflation and the state of the labour market are obviously central to the Fed's response. Tomorrow, the release of the Employment Cost Index, which tracks employees' total compensation, will provide further insights into the possible wage-price spiral. The figure jumped in the third quarter of 2021.

We also monitor the CDS High Yield as a sign of nervousness in the credit market. Back in 2019, the Fed had stopped its tightening cycle because the High Yield primary market had frozen up.

The shape of the yield curve is a classic indicator of future recession. An inversion (when short-term yields become higher than long-term yields) is typically a sign of a recession coming in 12-18 months. Currently, the differential between the 10-year yield and the 2-year yield stands at 65bps, which is within the range of a normal economic expansion. There is no reason to believe that a recession is around the corner.

DIFFERENTIAL BETWEEN US 10-YEAR AND 2-YEAR RATES (IN BPS)



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