FLASH: 05 MAY 2022

Fed: relief rally

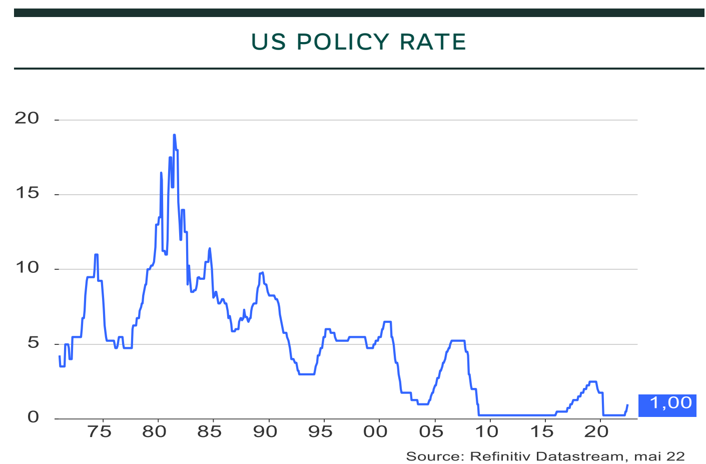
Summary

- No surprise in the Fed's decisions yesterday: 50 bps of interest rate hike as well as the reduction in the size of the balance sheet from 1 June via non reinvestment of maturing assets.
- But a positive reaction from the markets as 1)the Fed does not envisage massive hikes of more than 50 bps and 2)the neutral rate no longer seems to be very far away from market pricing.
- Our scenario remains for a less aggressive monetary tightening than expected by the market. We expect an additional 150 bps of rate hikes this year and a Fed funds rate at 2.75% at the end of 2023
- We expect US bond yields to fall over the next 12 months, in line with an economic slowdown and falling inflation. Our target is 2.25% for the 2-year yield and 2.50% for the 10-year yield. However, it cannot be ruled out that the 10-year yield will rise moderately above 3% in the coming months if inflation does not slow fast enough.

No surprise

The two decisions taken by the Fed on 4 May came as no surprise. The Committee will tighten monetary policy by increasing policy rates and reducing liquidity as the fight against inflation has become the number 1 priority. The Fed therefore decided to raise the Fed funds rate by 50 basis points (bps) to the 0.75% -1% range. It also announced a reduction in the size of its balance sheet on 1 June. It will do so in a non-aggressive way, through fewer reinvestments of maturing assets, and not through active sales of Treasuries or MBS.

US POLICY RATE



Source: BNP Paribas Wealth Management

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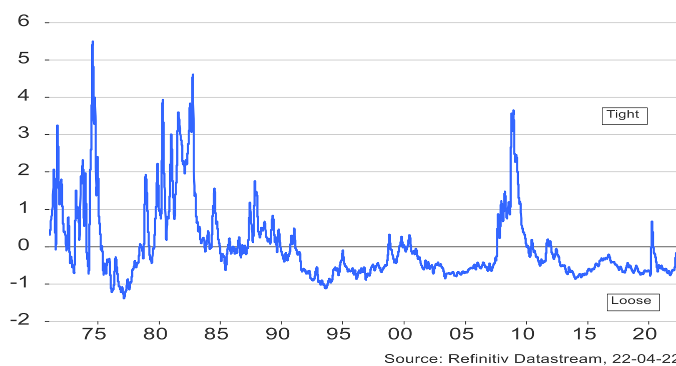
Positive market reaction

Equities rose (the largest post Fed rally since 2011 for S&P500), bond yields declined, especially short-term yields and the dollar depreciated. As a result, financial conditions eased yesterday, an unintended - and probably temporary - result as the Fed seeks to tighten them in order to slow down economic activity and thus inflation. Moreover, expectations about the pace of Fed funds rate hikes have fallen slightly.

FINANCIAL CONDITIONS HAVE TIGHTENED LATELY BUT ARE STILL LOOSE

Adjusted National Financial Conditions Index, Chicago Fed



Source: BNP Paribas Wealth Management

Two factors triggered the rally

1)No big moves are planned. The Fed expects further rate hikes, with 50 bps on the table for the next couple of meetings but is not actively considering big hikes. As a result, fears of an escalation with a rise of 75 bps almost disappeared.

2)The neutral rate discussion. The neutral rate is the rate that does not stimulate economic activity but does not slow it either. The Fed had hinted that it would raise its key rates until they were slightly above the neutral rate. It now estimates it to be between 2% and 3%, which is somewhat below what the market had anticipated. There was therefore too much monetary tightening in market expectations.

Our base case scenario

We believe that the Fed is hawkish to regain control of the inflation narrative and calm inflation expectations, but that it will eventually deliver fewer policy rate increases than the market expects as inflation is likely to slow sufficiently in the second half of the year. We expect an additional 150 bps of monetary tightening by the end of the year, with 50 bps in June and July. We expect a Fed funds rate of 2.75% at the end of 2023. The market has revised down its projections but remains more aggressive than us, with 190 bps of rate hikes expected by the end of the year and a Fed funds rate at 3.1% at the end of 2023.

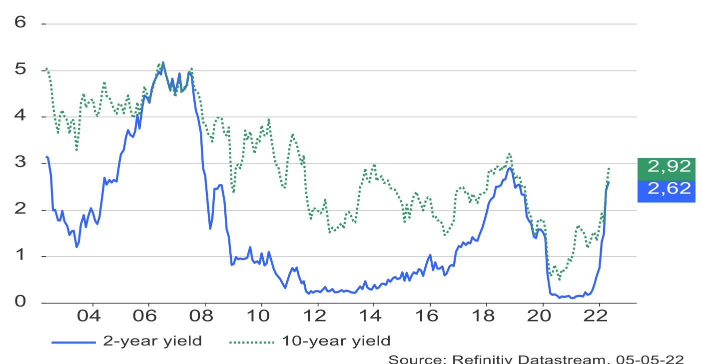
Outlook for short-term bond yields

The US 2-year bond yield fell by 12 bps during the FOMC meeting to close at 2.65%. Our 12-month target (2.25%) is below the current level as we believe the Fed will not deliver as many rate hikes as the market expects.

Outlook for long-term bond yields

The US 10-year bond yield fell by 3 bps during the FOMC meeting to close at 2.94%. It may rise to 3.25% over the next 2-3 months given a possible upward revision of rate hikes if inflation does not slow fast enough. However, over a 12-month horizon, we believe the US 10-year yield is likely to fall from its current level, as economic growth and inflation will slow down, allowing the Fed to raise its key rate less aggressively relative to market expectations. In addition, at 3%, the yield is attractive and long term US investors are starting to buy. Our 12 month target is 2.50% for the US 10-year bond yield.

US 2- AND 10-YEAR YIELDS



Source: BNP Paribas Wealth Management

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