MARKET COMMENTARY

The Fed tightens aggressively, aiming at least at a “softish” landing

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- **The expected 50bp rate rise and the announcement of the balance sheet reduction materialised, as the Fed continues to highlight the risk of higher inflation and remains confident on the strength of domestic demand and the labour market.**
- **With the lowest employment rate in five decades, strong wage growth and nearly two job openings per unemployed per person, the Fed is reasonably confident to be able to cool down inflation without harming the economy. It will therefore move quickly rates to the neutral level (2% to 3%) and then will decide whether to tighten further. A 50 bps hike is to be expected in both June and July.**
- **Quantitative tightening will begin on June 1 and will reach full speed (a monthly reduction of US$ 60 in Treasuries and US$ 35bn of MBS) after three months. We expect the balance sheet to reach its long term value by mid- 2025.**

The Fed confirmed its willingness to catch up with rising inflation by increasing the policy rate by 50bp for the first time since 2000 and warned about further inflationary pressures stemming from the war in Ukraine and lockdowns in China. Moreover, it laid out the plan for shrinking the balance sheet at roughly twice ad fast as in the previous quantitative tightening.

The press release reminded that the poor Q1 GDP figure conceals strong readings for both consumption and investment, and underlined again the healthy recovery in employment, probably aiming at reassuring that the sharp tightening needed to fight inflation should pose limited risks for the economy; the comparison with March is attached.

Getting back to price stability is good for everybody, as high inflation not just harms significantly the less well-off households, it also stands in the way of the smooth improvement of the labour market and therefore complicates both Fed’s mandates. During the first post meeting Q&A session held in person after two years, Chair Powell quickly pointed out that part of the spike in price is due to factors that the Fed cannot control, such as commodities and global supply chains. To minimise any risk pf a dangerous price spiral the Fed needs to put back demand and supply in check quickly. He also sketched how the FOMC plans the difficult task of delivering a soft (or “softish”) landing, starting with the labour market. Currently unemployment rate is at 3.6% the lowest level in 50 years and, wages are rising at the fastest pace in decades and there are nearly two job openings for any unemployed person. By tightening policy, the Fed aims at curbing labour demand without triggering any significant rise in unemployment, despite the expected (and hoped for) recovery in labour market participation.

Therefore, it needs to bring quickly back to policy rate to within the range of estimates of the neutral one (2% to 3%, the median of the March projections is 2.4%). Once there, data on activity and financial conditions will inform the decision of whether and to what extent go higher; if needed- Powell stresses several times- the Fed will not be shy to move rates above neutral. He also offered some guidance on the next moves: if the economy and financial markets proceed as expected two 50bps rate hikes will be delivered in June and July. Larger increases, like 75bp are not considered.

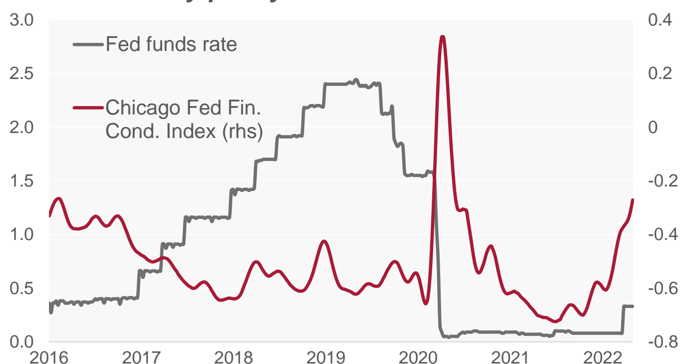
The almost unprecedentedly fast pace of tightening raises fears of recession. While acknowledging for the high uncertainty surrounding the global economy, Powell pointed to the strong momentum of consumption and investment and the exceptionally steady labour market. Moreover, and contrary to pas episodes of tightening ended in a recession, private sector balance sheets are in a good position with low household debt and high savings.

Powell dismissed that the bank has a credibility problem, pointed to the fact that the announcement of a much more active anti-inflation policy at the end of last year was immediately followed by a sharp tightening in financial conditions, just as the

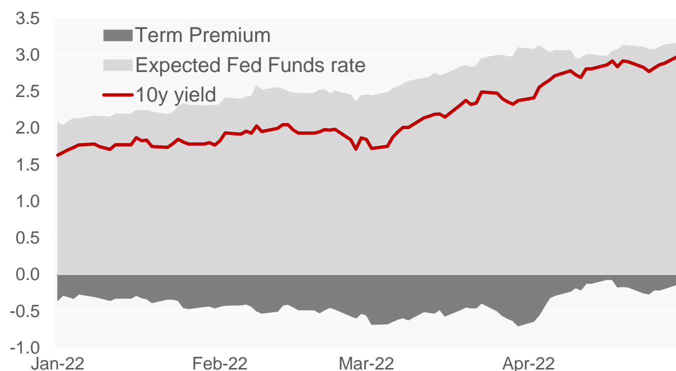
Fed planned. Indeed, the Chicago Fed index is already at its highest value since the Fed embarked in earnest in raising rates, in 2016.

Moreover, the FOMC gave content to its pledge to reduce in a fast and predictable way its balance sheet. From June 1, principal payments from securities held in the portfolio will be reinvested to the extent that they exceed monthly caps. For the first three months the caps are set at US$ 30bn for Treasuries and US$ 17.5bn for MBS. Afterwards they will rise to respectively US$ 60bn and US$ 35bn. If the value of maturing Treasuries in a month is lower then the cap, T-bills will be run down to fill the gap. The process will stop when the size of liabilities to be matched (reserve balances) is somewhat above the level consistent with ample reserves. We expect the balance sheet to go back to its long-term size by mod 2025.

Relief for the lack of additional surprises led to a market rally. After the announcement both the S&P and Nasdaq composite rose to their weekly high. The two-year Treasury yield lost 12 bp to 2.66%.



Source:Fed Board, Chicago Fed, Datastream, GIAM



Source:NY Fed, Datastream, GIAM

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