

MARKET COMMENTARY

The Fed looks through market volatility and starts normalisation

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- A rate hike in March is a done deal. The better economic situation compared with 2015 will allow a faster withdrawal of monetary stimulus. This implies for us four hikes this year, with risks tilted to more increases, but 50 bps moves have not been ruled out. Balance sheet reduction will begin in July at the earliest, as it will take at least two meetings for the FOMC to define the details. Predictability remains the byword.
- Full employment has been reached, and the extremely strong labour market, indicates according to the FOMC that the economy can tolerate a fast pace of support reduction. Risks remain two sided, but Powell tended to concentrate on the upside ones for inflation, as supply bottlenecks will persist until next year.
- The hawkish message lifted the 2-year yield to where it was before the pandemic (1.09%) and hurt stocks. The FOMC does not appear worried about the recent market turmoil and believes that the tightening in financial condition just reflects the market revising expectations in line with what the Fed sought with the December hawkish pivot.

"The committee is of a mind to raise the federal funds rate at the March meeting assuming that conditions are appropriate for doing so.": chair Powell could hardly have been more straightforward on a decision that was anyway widely expected. Moreover, he hinted several times that the previous experience of policy normalisation is a poor guidance to the Fed's projected path. The US economy is much stronger than at the end of 2015, the labour market is much tighter, and inflation higher and expected to remain above target for long. This implies that, rate rises, and balance sheet reduction will proceed at a faster pace.

The policy shift was very explicit already in the press release. The FOMC signalled that inflation is above the 2% and hinted that the "strong" labour market closely resembles its idea of full employment. As expected, it stated that QE purchases will halve in February and stop in early March. The downside risks related to the sizeable increase in COVID cases deserved only a brief mention at the beginning. Moreover, in preparation to quantitative tightening, the FOMC released a list of principles that will guide the reduction of the balance sheet. It served to restate three important things: (i) the fed funds rate remains the main policy tool, (ii) QT will proceed by readjusting the amount of securities reinvested, and not by selling part of them, (iii) in the long run, the Fed will mostly hold Treasuries (i.e. will get rid of MBS), to minimise differences in credit allocation across sectors.

Most of chair Powell's analysis on the state of the economy was centred on the labour market: employment has reached the maximum level compatible with stable prices: hopefully will move higher along with participation. Yet, the record high number of jobs opening per unemployed person is, in the FOMC view, the best indicator that monetary policy can tighten without hurting job creation. On inflation, if anything the situation have worsened since the December meeting and Powell thinks he will raise by a few tenth his projection for year-end core PCE inflation (the committee's median was 2.7%). Price pressures will ease in the second half of the year, as bottlenecks gradually ease and the impulse of fiscal policy to growth turns negative, but risks remain clearly tilted to the upside. Growth will remain substantially above potential, and tighter policy is justified by the fact that price stability is critical to have a long-lasting expansion. There remains a lot of uncertainty, related to the evolution of the supply side: progress has been almost non-existent in the last months, despite the improvements in the second half of the year, bottlenecks will persist in 2023 too. The most relevant downside risks to growth, according to Powell, are related to a possible new wave of Covid and the impact of China's lockdown on the supply side. But these just deserved a quick mention.

Then, the two pillars of monetary policy clearly call for quick move away from accommodation, but apart from mentioning the lift-off in March, chair Powell provided few details on the possible path for rates. The possibility of a 50 bps hike was not ruled out: the FOMC has yet to discuss it; all decisions, including then also the terminal rate, will be strictly data driven.

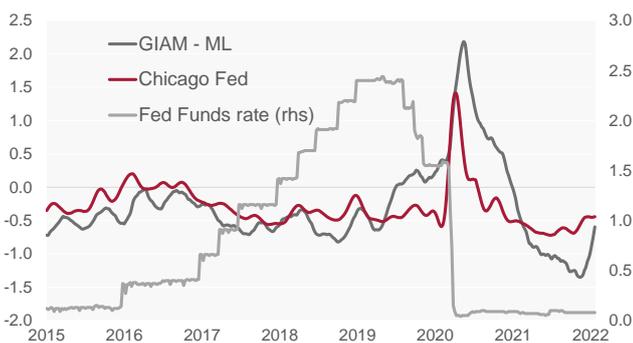
The discussion on how to shrink the balance sheet has just started and, according to Powell, it will take at least two meetings for the FOMC to agree on the details; but he pointed out that, compared with the post-Great Financial Crisis period, the Fed's balance sheet is much bigger and has a shorter duration. Another reason, on top of the stronger economy for a faster shrinkage. According to the principles just published, the balance sheet reduction is planned to operate in the background, and the policy rate remains the active policy tool.

The FOMC does not see the recent market turmoil as a particular concern; the tightening in financial conditions, according to Powell, reflects the change in market's view of the Fed policy. The policy shift announced in December has steered expectations in the direction the FOMC wanted. The flattening of the yield curve is not a cause for preoccupation the 2y-10 year spread is well within the historical norm and long rates are influenced by a lot of factor beyond the Fed's control. There are no particular issues on the financial stability side; the elevate level of some asset prices reflect risk appetite and do not constitute a relevant risk to the real economy, as the private sector's balance sheet is in a good shape and the banking sector well capitalised.

All in all, the Fed reaffirmed that what matters is the strong recovery, not the recent financial market gyrations, and the next weeks may test its ability to stick to this. The economy is in our view capable to withstand four rate hikes this year. A more aggressive path is more likely to involve a higher number of hikes rather than bigger ones, that may destabilise too much financial conditions. The timeline sketched by Powell is consistent with quantitative tightening beginning in July at the earliest.

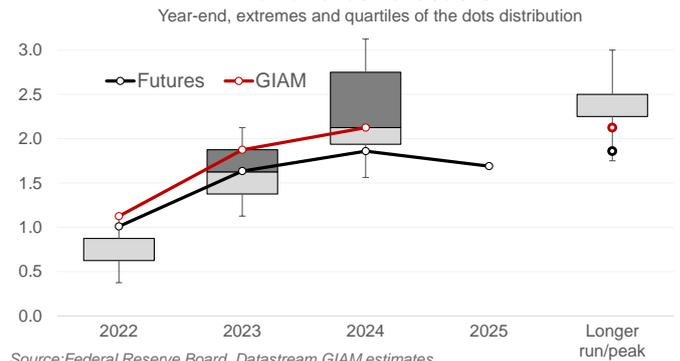
The distinctively hawkish tone of the meeting lifted interest rates, with the two year back to the pre pandemic (February 2020) level of 1.09%. The gains posted by the S&P and especially the Nasdaq earlier in the trading day were wiped out.

Financial Conditions Indexes and Fed rate



Source: Datastream, GIAM

Distribution of the FOMC "dots" and Fed fund rates forecasts



Source: Federal Reserve Board, Datastream, GIAM estimates

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