Focus —

FED: SANTA POWELL?

On Wednesday, the Federal Reserve provided multiple indications that its run of ultra-easy policy since the beginning of the Covid-19 pandemic is coming to a close, speeding the tapering of their monthly asset purchases program and signaling three rate hikes next year, in response to rising inflation.

Yet the markets reacted very positively. How to explain this "melt-up"? Will it last and does the Fed's "hawkish pivot" have any implications for our market outlook?

PRIVATE BANKING

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The Federal Reserve concluded its two-day meeting on Wednesday: Key takeaways and Bank Syz's take.

DECEMBER 2021

THE FACTS

The Federal Reserve concluded its two-day meeting on Wednesday. Key takeaways are the following:

- The Fed will be buying $60 billion of bonds each month starting in January, half the level prior to the November taper and $30 billion less than it had been buying in December. The Fed was tapering by $15 billion a month by November, doubled that in December, and will accelerate the reduction further come 2022. This puts them on course to conclude asset purchases by March, from the prior landing zone of around June, although this could be adjusted if warranted. It should also be noted that the vote to speed up QE tapering was unanimous, so it seems the new vice chair Lael Brainard also cares about price stability.
- After QE tapering wraps up, in late winter or early spring, the central bank expects to start raising interest rates, which were held steady at this week's meeting. Its updated projections of future interest rate rises (aka, the "dots") show a median three hikes next year, up from one shown in September. And while the last "dot plot" showed half of the 18 members ruling out hikes in 2022, all now agree that at least one will be needed. The longer-term, terminal rate view is unchanged, however.
- Inflation forecasts were revised up to 2.6% for headline PCE by the end of next year (2.2% previously), while the core measure is seen at 2.7% by end 2022 (vs. 2.3% before). The word "transitory" was retired;
- The Fed sees the economy continuing to grow. Its growth view for next year was revised up, although 2023's pace was revised down a touch.
- On the labour market, the Fed sees the jobless rate return to the 3.5% mark next year (vs. 3.8% previously), where it is likely to stay over its forecast horizon.

MARKET REACTION

Heading into Wednesday's FOMC, the consensus seemed rather clear: anything more than 2 rates hikes in 2022 would be viewed as clearly hawkish and would spark concern in the markets that the Fed is moving too fast.

And yet, despite the Fed's clearly hawkish pivot, stocks initially sank only to soar after Powell's conference call, with the S&P 500 closing at session highs, just above 4,700 and not too far from all-time highs.

The dollar initially spiked, before retreating, ahead of more ECB decision today.

U.S. Treasury yields rose, with the yield on the benchmark 10-year U.S. Treasury note climbing to 1.46% from 1.43% on Tuesday. Money markets now see a 90% chance of an April rate hike.

READ-THROUGH

Why did risk assets react positively to the Fed's hawkish pivot? There are several possible explanations.

The first assumption is that this outcome was largely built into equity expectations. Because the FOMC wasn't more hawkish, equities interpreted the Fed's conclusions as a sigh of relief and reversed course -at least for now.

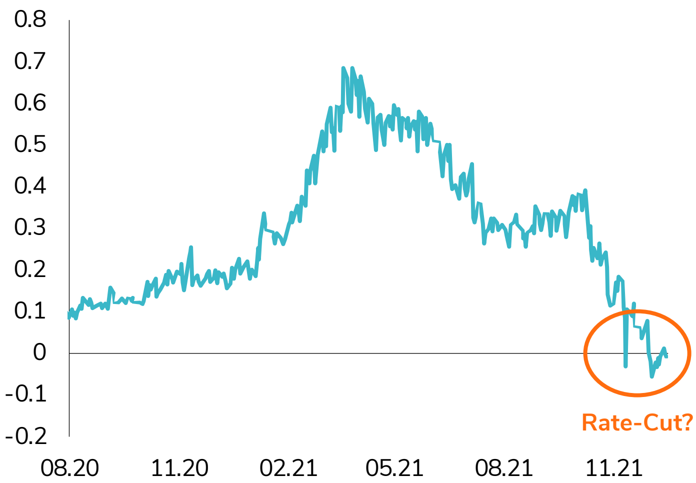
Another potential reason for the rally is investors focusing on growth rather than interest rates. Indeed, one takeaway from the press conference was that Fed Chairman Powell was rather upbeat about the economy.

Some suggested that the initial positive equity market reaction was due to investors gaining confidence in the Fed's willingness and ability to fight inflation. As a result, they are decreasing the odds of stagflation and policy error.

A more "technical" explanation is the market positioning pre-FOMC. Many investors and traders hedged aggressively ahead of the Fed meeting. Bearish sentiment was soaring as the 10-day average of the Cboe put-call ratio hovered near the highest level in 13 months. Many hedge funds added some shorts on tech names and the riskiest parts of the market (meme stocks, momentum plays, the "most shorted stocks", etc.). As the Fed announcement came out, many investors were forced to unwind hedges, triggering a massive gamma squeeze higher. Note that this short covering is also taking place ahead of Friday's options expiration day.

Yet another explanation can be found in the bond market. Indeed, the forward yield curve has already inverted with the market now pricing in an end to the tightening cycle in 2024 (see chart below). Indeed, the market believes that the Fed's aggressive tightening plans will force Powell to end tightening in the near future and immediately start the next easing cycle. In other words, the market is forward looking and basically sees the Fed's tightening cycle being over before it has even begun, looking forward for the next wave of liquidity to push risk assets to even higher level.

Market-Implied Rate Expectations from 2024-2025



Source: Bloomberg

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OUR TAKE

First, we believe that the initial market reaction should be interpreted with some caution. It is not uncommon following a monetary policy announcement to have some volatility. In fact, the market direction on the day of the announcement is not always the direction markets take in the weeks that follow.

Yesterday's FOMC statement is a major pivot from the Fed, prompted by clearer evidence that inflation is broadening. With these new forecasts, the Fed has moved in line with market thinking. The key question now is the timing of the first hike.

A first rate hike could be expected in March, depending on the evolution of Omicron. Should the U.S. see a massive, unprecedented surge in Covid-19 cases, with its load of unknown consequences for the economy, the Fed could delay the first hike until May, with the next moves later in the year.

Another hurdle that remains before the first rate hike is the labor market: "With inflation having exceeded 2 percent for some time, the Committee expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment." The return to higher U.S. labor force participation is expected to take longer. Fed Chair Powell noted that employers are having difficulty finding workers. Wage growth will help determine when the U.S. gets to full employment. Job openings and "quit rate" will also be key macro figures to watch out for.

As mentioned in our last Asset Allocation Insight ("Volatility for Christmas?"), we are concerned by the high level of valuations of some market segments (e.g. U.S. equities) at a time when monetary policies are experiencing normalization. This week's FOMC hawkish pivot confirms that one of the key market tailwinds – i.e monetary policy – will be much less supportive next year.

That being said, we also believe that global economic growth and earnings will partly offset the normalization of monetary policies in 2022. We also expect the most muted response to inflation in decades and thus real yields to stay negative (see our last Focus: "US economy: Lessons from the 40s"). This top-down-scenario leads us to keep a positive stance on risk assets and equity in particular.

A final comment: by signaling three rate hikes next year, the Fed has clearly shown its commitment to not stay behind the curve, de facto reducing the risk of monetary policy mistakes. Through their communication, they also gave themselves some flexibility in terms of timing and amount of rate hikes, i.e they might turn more or less hawkish depending on the macroeconomic outcome. This could indeed be Santa Powell's gift to the market …

For further information

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