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Flash —

No Fed Put

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PRIVATE BANKING

No Fed Put

Key takeaways from FOMC announcements and a seemingly hawkish Powell.

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Key messages were the following:

1) A 25 basis points increase is likely coming in March: this was expected and made clear that a 50 basis points is not in the cards;

2) FOMC Committee indicated that monthly Quantitative Easing (QE) asset purchases will proceed at just $30bn in February, indicating that the programme will end in March, as expected, i.e the end of QE is NOT happening immediately;

3) Quantitative Tightening (QT) will NOT start immediately as "balance sheet shrinking will start AFTER rate-hikes commence". There was thus nothing new on balance sheet reduction.

The Initial market reaction was rather positive. The Dow rose by 200 points and US 10-year Treasury yield was contained (+2bps).

However, market action turned lower following the conference call held by Fed chair Jerome Powell. The Dow closed down 130 points (-0.4%), which is the market's worst performance on an FOMC day in at least a year. The US 10-year yield ended up 9 basis points while the US 2-year closed up 12 basis points, which is the biggest jump in 2Y yields since March 2020 as rate-hike expectations rose significantly with a 65% chance of a 5th hike this year being now priced in the market. The yield curve flattened while US 5 year real yield spiked. The dollar rose while gold and bitcoin dropped.

So why was the FOMC statement seen as hawkish by the market?

a) Powell's comment "I think there is plenty of room to raise rates without threatening the labor market" was a sign that the tightening cycle might be more lengthy than expected;

b) "Asset prices are somewhat elevated (...) They now pose a threat to financial stability" was seen as clear statement that there is NO FED PUT, i.e the Fed is unlikely to turn less hawkish just because markets are pulling back;

c) "The Fed is willing to move sooner (...) and perhaps faster than last time in shrinking the balance sheet" is a hint that quantitative tightening (QT) could end up being stronger and happening sooner than expected. Note that this was counter-balanced by "we want the balance sheet to be declining in a predictable manner (...) by adjusting the reinvestment of maturing debt".

Key takeaways

Markets still need to go through an adjustment process and price-in the fact that the FED will need to normalize policy through rate hikes and by shrinking the Fed's balance sheet. The FOMC statement also suggests that there is no Fed put at this stage, meaning the Fed doesn't want to put itself in a corner and backtrack on its plans to normalize monetary policy just for the sake of putting a halt to equity market correction.

Investment conclusions

We continue to believe that equity markets are likely to go through a choppy period with some spectacular pullback and reversals. This will last the time it will take for the bond market to price in a tighter Fed policy. We think that there is still potential for long-term yields to rise further but the magnitude of the rise is not expected to be as spectacular as the one we observed over the last few weeks.

In a nutshell, the liquidity context is less supportive than last year and volatility is expected to be on the rise. While monetary policy is denting sentiment and valuations, it is unlikely to put an end to the corporate profits cycle. We think that high single-digit earnings growth in developed markets is achievable this year and this should be enough to extend the current bull market.

As mentioned earlier this week (see our FAQ Flash note), a few adjustments were implemented in our discretionary portfolios. This was due to the fact that our market factors indicators have been deteriorating, leading our proprietary risk-based model to trigger a modest first-step of de-risking of the portfolios (between 3% and 4% equity reduction in balanced portfolios).

Note that the portfolio protections (lookback put-spread options) which have been in place since the end of last year and some exposure to broad-based commodities and gold have helped to offset part of the negative performance contribution by equity markets.

From a country and style perspective, we continue to favor a mix of secular plays (large-caps quality growth names mainly in the US) and some tactical value / cyclical exposure (hence a preference for regions such as Europe and Japan). Indeed, the shifting-rate environment has been a catalyst for style rotation within equity markets. Value investments have outperformed growth investments during this phase, and this leadership is likely to continue as long as we stay in this period of adjustment.

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