Hawkish fed but not more than feared

Yesterday, as expected, The Federal Reserve increased its benchmark interest rate by half a percentage point, in line with market expectations. In this note, we highlight the key facts, market reaction and share our view.

Market reaction

Stocks moved sharply higher when Fed Chair Jerome Powell said the central bank was NOT considering a 75 basis point (bps) hike in future meetings.

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The facts

The Fed hiked rates by 50 basis points, as expected. That is the biggest rate-hike since the bursting of the Dot-Com bubble in May 2000.

Quantitative Tightening (QT) should begin on June 1st and will be initially capped at $47.5 billion (bn). Three months later, it will grow to $95bn while the consensus was for $95bn as of now. This news is thus “dovish”. The Fed's QT plan means the balance sheet will shrink by $522.5bn by year-end (current size is $8.96 trillion).

In the press conference, Chairman Powell said he still believes in a soft landing thanks to accumulated savings, a stronger balance sheet and a tighter labor market: "The U.S. economy is very strong and well positioned to handle tighter monetary policy."

The Fed is “moving expeditiously” to combat rising inflation which has hit consumers hard, said Chairman Jerome Powell to start the central bank’s post-announcement news conference. “Inflation is much too high and we understand the hardship it is causing” he said. “We have both the tools we need and the resolve it will take to restore price stability on behalf of American families and businesses.”

The Fed added that they are highly “attentive” to inflation risks which could be seen to signal a hawkish tone but overall this is not more hawkish than expected.

Interestingly, the Fed shifted the description of “transitory” from inflation to the economy. In other words, they acknowledged the weakness in the economy, but they suggested this was temporary and household spending and business spending remains strong. This is an interesting way to support the need for more rate hikes and was indeed a hawkish message.

The FOMC estimates that the neutral rate is between 2% and 3%. The Fed added they will not hesitate to go beyond the neutral rate if necessary.

Market reaction

The Dow Jones rallied 900 points yesterday. Stocks moved sharply higher when Fed Chair Jerome Powell said the central bank was NOT considering a 75 bps hike in future meetings.

It sounds a bit weird to see stocks rallying the day we get the biggest rate hike in 22 years, but we need to keep in mind yesterday’s Fed decision was extremely well-telegraphed and priced in. The bar was high for a hawkish surprise and equity investors were thus relieved by the fact the Fed “package” included some “dovish” news (e.g no acceleration in terms of the pace and magnitude of hikes to come, amount of QT on June 1 being half of what was expected) – hence the rally.

In terms of market implied policy at year-end, expectations for December went down by 18 bps (from 2.98% to 2.8%).

The short-end of the US yield curve was trading 10/15 bps lower and the long-end of the curve eased only very slightly (-2/5 bps). We thus got a bull steepening of the US yield curve by 7 bps for the 2-10 year.

We note that the credit market rebound was far from being spectacular: CDX High Yield spreads only tightened by 10bps while they have widened by 80 bps since the beginning of April.

Our view

For the past nine months, the Fed has had to try to close the large and growing gap between its still ultra-accommodative monetary policy based on the “transitory inflation” thesis, on the one hand, and high and rising inflationary pressures across all segments of the US economy on the other.
As a reminder, in September 2021, Fed members didn’t expect even one single rate hike in 2022! They have found themselves far (and even very far…) behind the curve and have had to catch-up with the reality of the situation, i.e an economy which is growing above potential, with a strong and tight labor market fueling upward pressure on wages and amplifying supply-related inflationary pressures.

Yesterday’s meeting signaled that they are catching-up with what the market expects from them. The Fed is now in position to be more focused on inflation than on employment. It’s been a very long time since we’ve seen the U.S. central bank focused this way. Jerome Powell and the Fed appeared to be satisfied with current market expectations around the pace of rate hikes for the remaining of the year, i.e a Fed Fund rate in the 2.75%/3% range by the end of 2022. This can hardly be qualified as “dovish” as it still represents a significant amount of monetary policy tightening, but it suggests that the Fed has closed its “credibility gap” and feels they are re-gaining control of the situation, which was clearly not the case since the end of last year.

From now on, the plan is therefore to deliver on the expected monetary policy tightening as long as the economy remains on its firm growth trajectory. Interestingly, there was no strong commitment beyond the next “couple of meeting” for which additional 50 bps rate hikes have clearly been signaled by Mr Powell, in line with market expectations. Beyond that, and as it should always be, the continuation of the rate hike cycle will depend on growth and inflation data. The evolution of the US economy during the second half of the year will dictate whether the Fed has to turn more “dovish” or more “hawkish”. But at least, and at last, Fed members can now look at the situation from a more comfortable and balanced point of view.

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