Confidence must be earned

Amundi ASSET MANAGEMENT

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25-26 January FOMC review: giving the all clear for March hike

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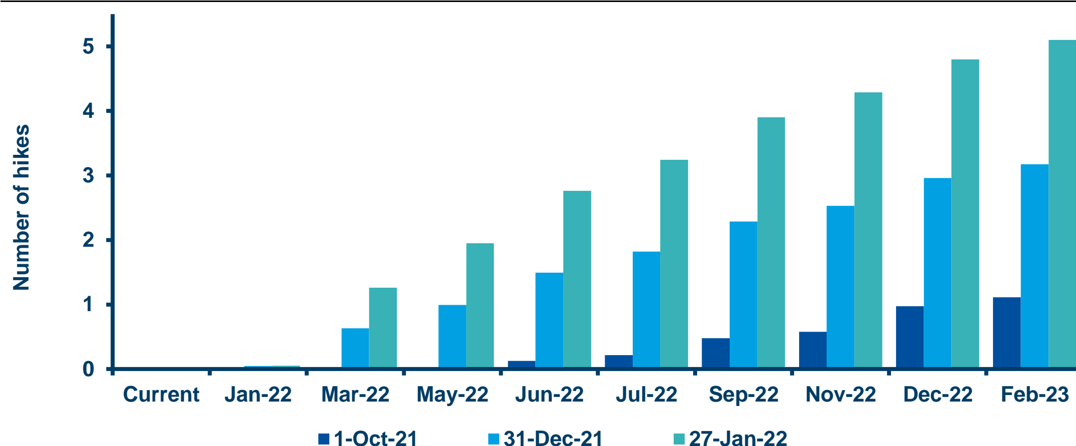
- ***FOMC statement**: **it was consistent with investor and market expectations.** With its two criteria having been met (price stability and full employment), the Fed indicated that the start of the rate normalisation cycle is soon. The Fed probably avoided referring to the next meeting scheduled in March to give them optionality should external events have a detrimental impact on growth. The Fed recognised that the recent rise in Covid-19 cases has weighed on short-term growth prospects, but would not be long lasting. The asset purchase programme will end in early March.*
- ***Press conference:** Chair Powell surprised investors with his hawkish tone. He did not explicitly rule out future actions such as hiking the policy rate at every meeting this year or increasing the policy rate in increments greater than 25 basis points (bp). The Fed appears uncomfortable with the high level of inflation and its persistence. While the statement did not include a date when the rate hiking cycle would begin, Chair Powell said they will decide in March, but most on the FOMC are looking to hike in March. He stated that the Fed funds rate will be the primary means to tighten policy. Quantitative tightening (QT) will occur only after the start of the rate-hiking cycle. The Fed will allow securities to roll off the balance sheet, presumably swatting back the prospects of the Fed immediately selling assets. The balance sheet principles pulled forward QT expectations and could begin as early as June.*
- ***Market reaction:** Financial markets sold-off following the press conference. US Treasury yields rose across the curve, leading to a flattening of the yield curve. Equity markets sold-off modestly, with the S&P 500 index closing at -0.2%. Overnight the Nikkei index sold-off over 3%. Today, European equity markets are selling-off more heavily, except for the German DAX index. The dollar rallied 0.5% notably against low -yielding currencies like the euro, Japanese yen, and Swiss franc.*

The hawkish pivot by the Federal Reserve (Fed) in November and December set the scene for taking a big step toward normalising policy and formally acknowledging the need to exit various aspects of its emergency accommodation. Yesterday's Federal Open Market Committee (FOMC) statement was drafted to prepare markets for policy rate 'lift-off' in March and reinforce current market implied policy expectations. The statement delivered on both goals and, as such, there was little initial market reaction. It was not until Chair Jerome Powell's surprisingly hawkish press conference that US interest rates shifted higher, the yield curve flattened and other financial markets sold-off.

Fed funds futures now predict more hikes



Source: Amundi, Bloomberg. Data is as of 27 January 2022.

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"Overall, the statement was largely consistent with investor and market expectations."

FOMC statement: green light to hike

There were four changes to the FOMC statement:

- The Fed modified the language around inflation and the labour market by stating that inflation is now "well above 2%" and the labour market is strong.
- With its two criteria having been met (price stability and full employment), the Fed indicated that the start of the rate normalisation cycle is coming soon. The Fed probably avoided referring to the next meeting scheduled in March to give them optionality should external events like geopolitical tensions in Eastern Europe or domestic considerations such as the pick-up in Covid-19 cases have a detrimental impact on growth.
- The Fed stated it would formally end its asset purchase programme in early March.
- The Fed recognised that the recent rise in Covid-19 cases has weighed on short-term growth prospects, but would not be long lasting.

Overall, the statement was largely consistent with investor and market expectations.

Press conference: Powell strikes a hawkish tone

Given the hawkish tone at the November and December press conferences, we had expected Chair Powell to strike a balanced tone this time. He did not and surprised investors with his hawkish tone. Some notable takeaways from his press conference:

- In some respects, it is what Powell did not say during the press conference that was as insightful as what he did say. In an effort to keep all policy options on the table, **Powell did not explicitly rule out future actions such as hiking the policy rate at every meeting this year or increasing the policy rate in increments greater than 25 bp**. The Fed appears uncomfortable with the high level of inflation and its persistence. Several times during the press conference, Chair Powell reiterated the difference between the current and previous economic cycle. He repeated that growth and inflation are much stronger than the last tightening cycle. It is understandable that their policy reaction function may need to change as well.
- While the statement did not include a date when the rate hiking cycle would begin, Chair Powell said they will decide in March, but most on the FOMC are looking to hike in March.
- **Chair Powell highlighted the four principles that will guide the Fed toward balance sheet run-off or QT**:
  - He stated that the Fed funds rate will be its primary means to tighten policy. This will dispel a view in the markets that an early start to QT could mean less rate hikes towards the end of the cycle.
  - QT will occur only after the start of rate hiking cycle.
  - The Fed will allow securities to roll off the balance sheet, presumably swatting back the prospects the Fed will immediately sell assets.
  - Finally, "***the Committee is prepared to adjust any of the details of its approach to reducing the size of the balance sheet in light of economic and financial developments."***

  The last point is key as it preserves the policy 'optionality' that is valued by the Federal Reserve. Powell mentioned that QT will be discussed at the March FOMC and probably one more after that. The balance sheet principles pulled forward QT expectations and could start as early as the June FOMC meeting.

"Powell did not rule out explicitly future actions such as hiking the policy rate at every meeting this year or increasing the policy rate in increments greater than 25 bp."

- Powell was not concerned about the recent equity market sell-off. **He characterised asset price valuations as elevated**. Chair Powell stated that the FOMC focuses on the implications of the equity market through the lens of financial stability and economic growth. He did not think the recent equity market sell-off would have material impact either. **Bottom line: the equity sell-off needs to be larger before the Fed becomes more concerned.** The strike on the Fed or Powell 'put' has been lowered.

Market reaction and investment implications

Financial markets sold-off following the press conference. US Treasury yields rose across the curve, leading to a flattening of the yield curve. Equity markets sold-off modestly, with the S&P 500 index closing -0.2%. Overnight the Nikkei index sold-off over 3%. Today, European equity markets are selling-off more heavily, except for the German DAX index. The dollar rallied 0.5% notably against low-yielding currencies like the euro, Japanese yen, and Swiss franc.

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Definitions

- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Curve flattening:** A flattening yield curve may be a result of long-term interest rates falling more than short-term interest rates or short-term rates increasing more than long-term rates.
- **Monetary policy reaction function**: A function that gives the value of a monetary policy tool that a CB chooses, or is recommended to choose, in response to some indicator of economic conditions.
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Quantitative tightening (QT):** The opposite of QE, QT is a contractionary monetary policy aimed to decrease the liquidity in the economy. It simply means that a CB reduces the pace of reinvestment of proceeds from maturing government bonds. It also means that the CB may increase interest rates as a tool to curb money supply.

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