The views expressed in these posts are those of the authors and are current only through the date stated. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance fund. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness.

Amid Rising Inflation Forecasts, Fed Turns Hawkish

By: Eric Stein, CFA | January 7, 2022

Boston - Only a few trading days into 2022 and we have seen a rapid increase in interest rates for two distinct reasons: Omicron and inflation.

Prior to the most recent Federal Open Market Committee (FOMC) meeting, the markets were broadly pricing in the effects of the Omicron variant that, while highly contagious, has proved to be much less lethal than previous variants. The situation we observed in South Africa — with cases spiking rapidly and then declining just as quickly — seems to be playing out in other parts of the world, although the U.S. has yet to hit its peak. Following a bump up in rates initially, there now appears to be less anxiety about Omicron from a longer-term perspective.

However, the hawkish December FOMC minutes released this week, which suggested rate hikes "sooner or at a faster pace" than previously expected, led to rate increases across the yield curve, along with a little more flattening as the Fed's concern about inflation heightened.

The Fed is telegraphing the end of quantitative easing (QE), which now seems to be targeted for mid-March 2022, according to the FOMC minutes, likely followed by a series of interest rate hikes in 2022.

Watching the Fed's balance sheet

The end of QE will shrink the Fed's balance sheet by slowing the pace of its expansion. In other words, the balance sheet will still increase but at a smaller rate than it was before. For some period, the balance sheet should remain steady, then it should start to contract at some point.

Based on the Fed minutes released this week, the market's expectations for the timing of that balance sheet contraction got pulled forward. That led to the sell-off we have witnessed across the bond market as investors reacted to the Fed's focus on tightening financial conditions.

Raising forecasts of inflation and expectations of rate hikes

Additionally, the Fed raised its current forecast of inflation to run at 2.6% next year, an increase over the 2.2% it projected last September. There is little doubt the central bank is a bit more concerned about inflation measures broadly, which has also contributed to some of the bond market sell-off. As a result, the market has increased its expectations of Fed rate hikes.

Now in 2022, markets are certainly not pricing in that high of a terminal federal funds rate — that is, the rate consistent with full employment and capacity utilization — but they are pricing in a little quicker pace of getting to higher rates than previously. I believe that was another driver of the bond market sell-off.

That said, from a market perspective, expectations of how high the fed funds rate could go remain low. We are experiencing a unique period in time when the market expectation is below the Fed's dot plot — that well-known visual representation of policymakers' expectations for future interest rate changes.

Going forward, both Omicron and inflation are likely to drive the markets to varying extents. The market's concern about the impact of the latest COVID variant may be waning, but if the situation were to change, I expect markets would move.

As for inflation, the markets are pricing in a more hawkish stance from the Fed, along with other central banks in developed markets. While I expect this to be a theme across global markets, I do not anticipate that it will follow a straight path.

Bottom line: I believe the Fed intends to slowly but surely tighten financial conditions, not moving too quickly. The Fed's primary goal is to moderate inflation without pushing back too hard against the recovery. I expect a tightening bias for the balance of 2022.

Eric Stein, CFA
Chief Investment Officer
Fixed Income
Eaton Vance Management

"The Fed's primary goal is to moderate inflation without pushing back too hard against the recovery. I expect a tightening bias for the balance of 2022."

Marketing Communication

To report a website vulnerability, please go to Responsible Disclosure.

Eaton Vance is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley.

This site (https://global.eatonvance.com) is operated by Eaton Vance Management (International) Limited ("We"). We are a limited company, registered in England and Wales under company number 4228294 and have our registered office at 125 Old Broad Street, London, EC2N 1AR. Our VAT number is 762717416. Eaton Vance Management (International) Limited is authorised and regulated by the Financial Conduct Authority ("FCA") and is entered on the FCA's register with register number 208634.
Eaton Vance Management (Registration No. 1121368) and Parametric Portfolio Associates LLC (Registration No. 1217626) are the registered trade marks of The Eaton Vance Group.

Information on this website does not constitute an offer to sell, or a solicitation of an offer to purchase, securities in any jurisdiction to any person to whom it is not lawful to make such an offer. It is your responsibility to be aware of and to observe all applicable laws and regulations of any relevant jurisdiction. The information on this webpage is not intended for U.S. residents. To visit our U.S. website please click here. Information on this website does not constitute an offer to sell, or a solicitation of an offer to purchase, securities in any jurisdiction to any person to whom it is not lawful to make such an offer. It is your responsibility to be aware of and to observe all applicable laws and regulations of any relevant jurisdiction. The information on this webpage is not intended for U.S. residents. To visit our U.S. website please click here.

The views expressed are those of the authors and are current only through the date stated. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance fund. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness.

In the EU this website is operated by MSIM Fund Management (Ireland) Limited (MSIM FMIL). The business of Eaton Vance Global Advisors Limited was transferred to MSIM FMIL on 1 October 2021. MSIM FMIL has been appointed as management company of the Eaton Vance International (Ireland) Funds plc and is responsible for the distribution of the funds together with the distribution of Eaton Vance strategies and strategies of Eaton Vance affiliates. For any queries in respect of the products and strategies referred to on this website, please contact MSIM FMIL at 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM FMIL is regulated by the Central Bank of Ireland with Company Number: 616661.

Outside of the US and EU, this material is issued by Eaton Vance Management (International) Limited ("EVMI") 125 Old Broad Street, London, EC2N 1AR, UK, and is which is authorised and regulated in the United Kingdom by the Financial Conduct Authority.

This material is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

This material does not constitute an offer to sell or the solicitation of an offer to buy any services referred to expressly or impliedly in the material in the People's Republic of China (excluding Hong Kong, Macau and Taiwan, the "PRC") to any person to whom it is unlawful to make the offer or solicitation in the PRC.

The material may not be provided, sold, distributed or delivered, or provided or sold or distributed or delivered to any person for forwarding or resale or redelivery, in any such case directly or indirectly, in the People's Republic of China (the PRC, excluding Hong Kong, Macau and Taiwan) in contravention of any applicable laws.

In Singapore, Eaton Vance Management International (Asia) Pte. Ltd. ("EVMIA") hol ds a Capital Markets Licence under the Securities and Futures Act of Singapore ("SFA") to con duct, among others, fund management, is an exempt Financial Adviser pursuant to the Financial Adviser Act Section 23 (1) (d) and is regulated by the Monetary Authority of Singapore ("MAS"). Eaton Vance Management, Eaton Vance Management (International) Limited and Parametric Portfolio Associates® LLC holds an exemption under Paragraph 9, 3rd Schedule to the SFA in Singapore to conduct fund management activities under an arrangement with EVMIA and subject to certain conditions.

EVMI is registered as a Discretionary Investment Manager in South Korea pursuant to Article 18 of Financial Investment Services and Capital Markets Act of South Korea.

Morgan Stanley Investment Management (Australia) Pty Limited ACN 122 040 037, AFSL No. 314182 arranges for Eaton Vance Management International Limited to provide financial services to Australian wholesale clients. This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accepts responsibility for its content. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

We are actively incorporating accessibility practices, such as those outlined in the Web Content Accessibility Guidelines, into our go-forward website design and content development to make information more accessible and user-friendly. In addition, we are developing a multi-year accessibility strategy and content guidelines that further support the use of assistive and adaptive tools. Our ultimate goal is to meet federal guidelines and policies or provide equivalent accommodations and service support for all customers.