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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.



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