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2022 Outlook: COVID and Inflation Seen Driving Pace of Fed Tightening

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"Hawkish December FOMC minutes released in early January suggested rate hikes 'sooner or at a faster pace' than previously expected, while raising forecasted inflation to 2.6% in 2022 — leaving little doubt that the central bank is a bit more concerned about inflation measures broadly."

Boston - Just weeks into 2022, we have already experienced 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 in early January suggested rate hikes "sooner or at a faster pace" than previously expected, while raising forecasted inflation to 2.6% in 2022 — an increase over the 2.2% 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.

Hikes in the fed funds rate

The hawkish Fed minutes led to rate increases across the yield curve in January, along with a little more flattening. Despite the sell-off, we are in an unusual period in which the market's expectations are below the Fed's.

Prior to the recent FOMC minutes, the market had been projecting increases in the federal funds rate from effectively zero to 1.5% through 2024, based on futures pricing; now it is expecting the fed funds rate to reach 1.75%. In contrast, the Fed sees the funds rate hitting 2.1% by 2024.

Another change in the market outlook involves the timing of expected rate hikes. Previously, the market predicted rate hikes would end in 2023, but now the forecast is for seven hikes through 2024. This suggests that the market believes the economy is strong enough to handle the tighter monetary conditions.

Watching the Fed's balance sheet

The Fed's tightening of monetary conditions continues to be led by the winding down of quantitative easing (QE) — the end of QE now appears to be targeted for mid-March 2022, according to the FOMC minutes, likely followed by the rate hikes noted earlier.

Ending QE implies the Fed's balance sheet will eventually shrink. Initially it will

still increase, but at a smaller rate than before. For some period, the balance sheet should remain steady, then at some point it should start to contract. Based on the Fed minutes released on January 5, the market's expectations for the timing of that balance sheet contraction got pulled forward.

Omicron/inflation dynamic

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. 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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