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Markets and Economy

Start of Tightening Cycle Signaled by Hawkish Powell Comments

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Boston - The January 25-26 meeting of the Federal Open Market Committee resulted in a general statement that was fairly neutral. Fed Chair Jerome Powell's hawkish comments were what prompted the market response, with yields rising significantly more at the front end —resulting in a big curve flattening — although yields were up across the curve. The U.S. dollar strengthened and equities moved lower in a risk-off environment.

The Fed certainly seemed a little more concerned about inflation. For example, when asked about the possibility of hiking by 50 basis points (bps) — instead of the 25 bps increases during the last tightening cycle in 2015 — in Powell didn't push back too hard. He emphasized the differences between the two cycles and appeared to suggest that a faster pace might be appropriate this time, adding that the Fed would need to be "nimble."

My own view is that a 50 bps hike is still unlikely *right away*, but the Fed could certainly do 50 at some point, and maybe a little earlier than the markets were expecting before. It is clear that the Fed plans to begin raising rates in March, which was all but signaled during this meeting.

"The Fed may be fine with volatility in cryptocurrencies or technology stocks, which were two major beneficiaries of the ultra-low rate environment, as well as some broader equity market instability. If significant volatility spreads to core credit markets, however, the Fed's reaction might be different."

QE lives on — barely

By contrast, the Fed's signals on its balance sheet activity — namely, the scheduled winding down of quantitative easing (QE) by March —were what I would describe as neutral to dovish. That's mainly because the Fed could have stopped QE now, but chose to continue with small QE purchases and tapering until March. And Fed policymakers issued an addendum statement indicating that they are unlikely to sell assets directly.

Having said that, I would point out that the Fed has other tools to brake QE a little faster. For example, it could reinvest only a portion of the paydowns of U.S. Treasury issues (UST) and mortgage-backed securities (MBS) on the balance sheet. Soon the Fed may opt to *passively* contract the balance sheet rather than *actively* sell, which is effectively quantitative tightening (QT), but done in a theoretically less disruptive way.

It was clear, however, that the Fed wanted to distinguish between interest rate tightening and QE, with rate hikes designated as its main lever to tighten monetary policy against the risk of inflation.

Predictions for the Powell put

During the post-meeting press conference, some asked whether the Fed was

worried about the impact of tightening on financial stability, implying that the Fed wasn't all that concerned. This was similar to recent talk in the financial community that the "Powell put" is dead. Note that the *put* in this case — a term that originated with Fed Chair Alan Greenspan after the 1987 crash — is the central bank's willingness to loosen policy enough to prevent or mitigate financial market losses.

My view is that the Fed may be fine with volatility in cryptocurrencies or technology stocks, which were two major beneficiaries of the ultra-low rate environment, as well as some broader equity market instability. If significant volatility spreads to core credit markets, however, the Fed's reaction might be different.

In trading on January 26 after the press conference, credit spreads widened only modestly. I think the central bank doesn't want super-tight financial conditions, but given the elevated inflation outlook, policymakers do want to move directionally away from the extremely loose levels that have prevailed.

Regarding the Powell put, reports of its death may be premature, rather it has moved further "out of the money." In other words, the Fed won't move until or unless there is greater deterioration in financial stability.

Bottom line: Market volatility is likely to persist, with all eyes on the trajectory of inflation as investors try to assess how the Fed will react.

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