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Investment Strategy Bulletin

Fed committed to inflationary fight, as it embarks on twin tightening era

Investment Solutions

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As widely expected, the Federal Reserve raised interest rates by 50bps at its meeting ending 4 May, and signalled the start of quantitative tightening, with around USD 47 bn in monthly balance sheet reduction starting in June, and USD 95 bn per month from September onwards. This much was well-telegraphed to markets, as the Fed slams on the brakes with an aggressive monetary recalibration this year.

Markets took the fact that the Fed did not deliver a more 'hawkish' or negative surprise as something of a relief, following consistently more restrictive communications from officials since November 2021. Chair Jerome Powell said 75 basis points (bps) future hikes were "not something the committee is actively considering" for the next few meetings. Yet neither did the Fed deliver any positive surprises, and it stressed that the path ahead remains challenging. Having let inflation run too hot for too long, the Fed is doing all it can to catch up and slow demand, while reiterating that it has no tools to combat the succession of supply shocks (including the pandemic and the war in Ukraine) that have driven prices higher.

With rates now at 0.75-1.0% and consumer price inflation at a 40-year high of 8.5% in March – versus a 2% target – investors were more focused on how high Mr Powell indicated they could ultimately rise, in order to achieve the desired "neutral" target (which we see at around 2.5-3.0%) that neither slows nor spurs growth. But getting to neutral is the easy part. What comes next could prove even more challenging. Mr Powell indicated a series of 50bps rises ahead, and that the Fed will not be shy of pushing rates into restrictive territory if necessary, even though this is not their base case scenario for now.

In light of this, we expect a further 50bps hike in June, rate hikes frontloaded into the next nine months (50bps hikes in June, July and September), peaking at around 3% in Q1 2023, and almost USD 2 trn in balance sheet reduction over 2022-2023 (see chart, page 2).

Given conditions in the domestic economy, it was perhaps too early to expect the Fed to become less aggressive in its response to inflation. Despite signs of a broader global slowdown, the domestic economy is showing signs of overheating, and inflation is running well above any reasonable measure of flexible average inflation targeting.

Take GDP first: while Q1 data came in slightly below consensus expectations, a large part of the disappointment was down to negative net exports and volatile inventory levels. Consumption data – the biggest component of GDP – was extremely strong (which in turn drove up import demand), and business investment was growing at around 10%. Service consumption has recovered to above-trend levels, while the surge in goods consumption seen during the pandemic has still not receded.

On top of this, inflation is very high and the outlook has become both hard to predict and very challenging. The Ukraine war has resulted in high commodity prices, which could climb higher as EU countries mull a Russian oil embargo. Chinese lockdowns are putting global supply chains under additional strain. While core US inflation figures look to have reached a peak, this is very unlikely to change the Fed's near-term outlook. Annual wage growth of over 4.5% is above levels consistent with a 'normal' inflationary outlook, and price pressures have become broad-based. Even factoring in falling savings rates as stimulus measures end, we still forecast inflation above 6.0% by year-end.

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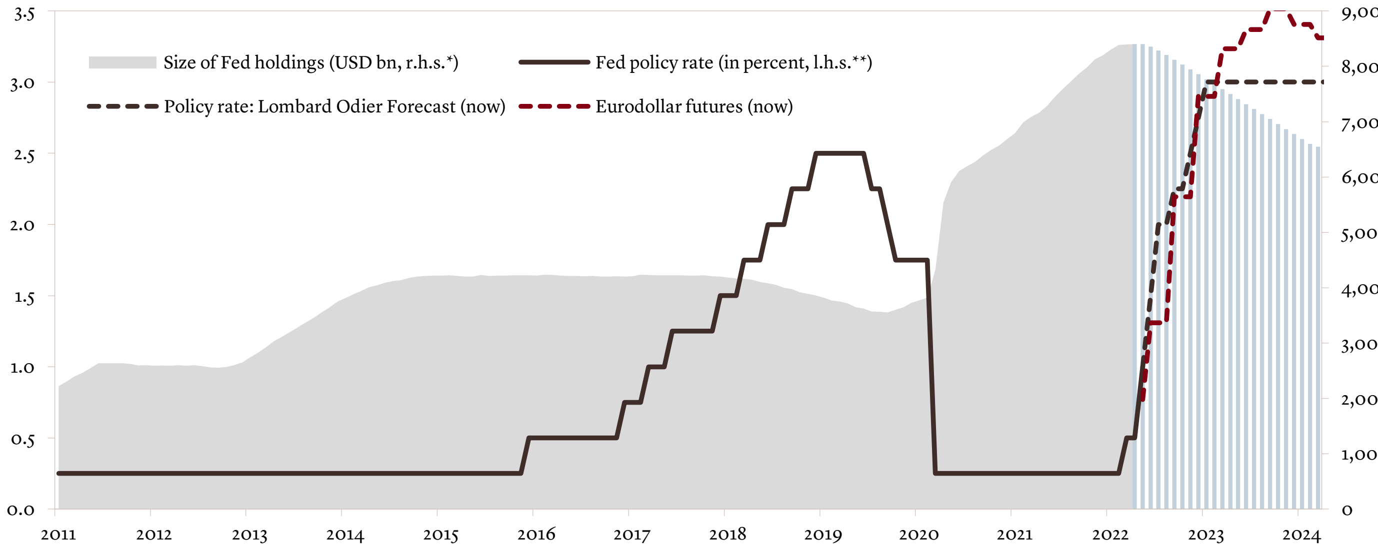
Faced with signs that favour severe action to combat inflation, the big question is whether the Fed can follow this path while also engineering a soft landing. While possible, this will be extremely challenging with unemployment this low and inflation this high. In the post-WWII era, the Fed has never successfully brought inflation down by four percentage points without causing a recession. The untested waters of 'quantitative tightening' (balance sheet reductions) are a particular concern. Last time the Fed unwound quantitative easing, in 2017, it was gradual. This time the run-off will be roughly twice as fast and the total amount to be shed from its balance sheet some USD 2 trn, versus around USD 800 bn last time around. The unwinding is happening in tandem with sharp rate rises, another first. No one is entirely sure what impact this will have on growth or markets.

One early warning sign will be US housing, an area we will be closely monitoring. The market is already starting to show signs of strain, with mortgage rates having risen to around 5.5% and high prices deterring first-time buyers and slowing activity. The Fed may have to actively sell some mortgage-backed securities as it runs off its balance sheet, potentially driving mortgage rates higher. While we do not expect a housing market crash, any slowdown here will feed into broader consumer and economic sentiment and activity. So far this year, markets have taken their lead from the Fed's rhetoric, and are pricing in sharp tightening that brings inflation down without an imminent US recession. We also believe that US growth will be above-average this year, but that the risks of recession have increased for 2023.

Samy Chaar, Chief Economist

Significant tightening ahead for US monetary policy

The Federal Reserve has given clear signs it will proceed with a rapid hiking pace



* right hand scale, **left hand scale
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