GLOBAL ECONOMY AND FINANCIAL MARKETS SHORT COMMENTARY

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Fed Tapering – Fed accelerates the pace of unwinding bond purchase, eye on three interest-rate hikes in 2022

With worries about the new fast-spreading omicron coronavirus variant giving investors pause, the growing concern among Wall Street that rising inflation could harm the economy likely a big part of what led the Fed to begin tapering. The shift is the latest sign of an acceleration and broadening of inflationary pressures, at the same time the labour market appears strong, have reshaped officials economic outlook and policy planning. The Fed signaled its inflation target has been met, and its announcement on ending the bond purchases paved the way for three-quarter-percentage-point interest rate increases by the end of 2022.

Accelerate the unwind of bond buying programme

In March 2020, Fed introduced a chain of stimulus policies to pump into the economy in response to the outbreak of Covud-19, in terms of massive bond purchasing programme at a rate of $120 billion per month and reduce interest rates to zero in order to stimulate a lagging economy. At the time, Fed officials said the process would continue until "substantial further progress has been made toward our maximum-employment and price-stability goals."

Inflation hotter than expected

While inflation is running at its 39 years high for consumer prices, the fastest on record in a sign that inflation pressures are becoming more ingrained and broad based. Prices rose at a 6.8% yearly rate as of November. By any measures, inflation is well above Fed’s target of 2%. Fed has been repeatedly stated that inflation is a ‘transitory’, until November’s meeting, the Fed decided the goals had been met and in November 2021 said that it was time to taper.

Participants “generally noted that, given their individual outlooks for the economy, the labor market, and inflation, it may become warranted to increase the federal funds rate sooner or at a faster pace than

participants had earlier anticipated," the minutes say.

Tapering

This was the point at which the Fed began reducing the monthly Treasury purchases and mortgage-backed securities. After the FOMC meeting in Nov, the Fed decided to reduce the monthly Treasury purchases by $10 billion and of mortgage-backed securities purchases by $5 billion. Fed Chairman Jerome Powell said the economy has made enough progress to justify removing stimulus that the central bank put in place early in the pandemic to prevent a major depression. Minutes for the FOMC meeting held on 14-15 December showed that most officials believe they could 'fast approach' their second goal of achieving labour market conditions consistent with maximum employment if recent strong growth continues. The word 'transitory' has also been banished from the minutes as Fed acknowledged that sustained increases in prices. In its new wording, the Fed said inflation was elevated.

U.S. consumer prices rose 6.8% YOY in November, the highest level since 1982.

Source: Bloomberg

Apart from the acceleration of unwinding bond-buying, also eye on rate hike.

At the same time, Minutes for the FOMC meeting held on 14-15 December also showed officials believed that rising inflation and the labour market appears strong could call for lifting short-term rates "sooner or at a faster pace than participants had earlier anticipated".

During the past year, the Fed always communicated with the market that they would not tap the brakes and raise interest rates before the Fed ends the bond purchasing programme. As the Fed eyed a faster timetable for ending the bond purchasing programme in 2022, it is highly like that it eyes to start raising the interest rates sooner in 2022, potentially as soon as in March.

Shrink in balance sheet.

Meanwhile, surprisingly that in the Minutes for the FOMC meeting held on 14-15 December, Fed officials started to discuss shrinking its almost $9 trillion balance sheet, which ballooned by about $4 trillion since

the start of the pandemic and represents roughly 40% of the US GDP. Some economists say how the Fed handles balance-sheet normalization may be more consequential for markets than the timing and pace of rate increases.

Back to 2015-2017, the Fed kept its balance sheet steady for around two years after it first raised interest rates in 2015 and just start to shrink its balance sheet in 2017. This time, the Fed may be much sooner to shrink its balance sheet. "Almost all participants agreed that it would likely be appropriate to initiate balance sheet runoff at some point after the first increase in the target range for the federal funds rate. However, participants judged that the appropriate timing of balance sheet runoff would likely be closer to that of policy rate liftoff than in the Committee's previous experience," as stated in the Minutes for the FOMC meeting held on 14-15 December, with officials noting that current conditions included a stronger economic outlook, higher inflation, and a larger balance sheet and thus could warrant a potentially faster pace of policy rate normalization.

The projection for inflation, unemployment rate and economic growth

According to the projection by the Fed in the aspects of inflation, unemployment rate, economic growth and interest rates, we can tell that the Fed has clearly shifted its policy direction.

The projection made by the Fed has significantly increased in the latest meeting

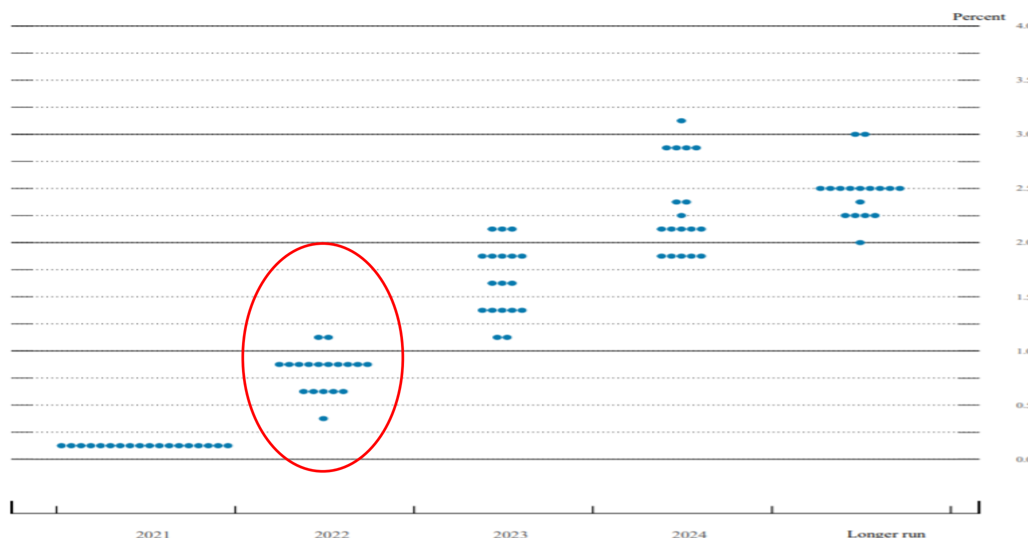
		2021	2022	2023
Expected Inflation	December's projection	5.3%	2.6%	2.3%
	September's projection	4.2%	2.2%	2.2%

Source: Federal Reserve

The committee sharply ratcheted up its inflation outlook for 2021, pushing it to 5.3% from 4.2%. For 2022, the expectation is now 2.6% for 2022 and 2.3% for 2023, both up from September.

At the same time, the unemployment rate projection for 2021 came down to 4.3% from 4.8% in September.

Dot Plot Projections



Source: Federal Reserve

According to the latest dot plot by the Fed officials released after the FOMC meeting in Dec, twelve Fed officials expected as many as three times rate hike coming in 2022, five officials claimed there will be rate hike twice in 2022, while one official expected only once in 2022. Most of the officials see with the other two rate hikes in 2023 and two more in 2024.

The pace of rate increases projected by officials is somewhat faster than what they foresaw in September, when the officials saw only one rate hike in 2022.

Stock Market

We expect the stock market is likely to be under pressure in the next few months, given that Fed's more hawkish stand than anticipated, both accelerating the pace of unwind bond purchasing programme, rate hikes or even balanced sheet shrinkage will add pressure to stock market, if the Fed's hawkish movement jeopardizes the economic growth and corporate profits, as well as downward pressure on stock market valuation.

The new variant virus is another uncertainty that every country is now facing. While officials in December cited the Omicron variant of the coronavirus as a risk, the Minutes showed officials didn't see it as a serious headwind for the economy. However, the number of confirmed coronavirus cases per day has significantly increased and hit its record high. US reports 1.35 million new cases recorded in a day (as at 10/1/2022). Despite the less severity and lower death rate that Omicron has posed, the new variant virus is much higher transmissible and the current vaccines are less effective in defending the virus. As a result, an unprecedented increase of affections and it would pose another wave of health crisis to the world.

Though most of the countries said that no matter how severe the pandemic, they would not impose significantly lockdown measures like what had been happened in the 1st half of 2020, as the number of confirmed coronavirus cases per day has significantly increased, some countries or cities eventually need

to re-impose some lockdown measures. For example, both Austria and Netherlands had already re-imposed lockdown respectively in Nov and Dec 2021.

Besides, even without the re-impose of lockdown measures, the economic activities may still be affected as some people may concern their own health and thus reduce their daily activities, such as less visits to restaurants and bars.

Most importantly, it seems that the current stock markets, no matter in US or in Europe, did not appropriately reflect the risk as most of them are still trading at near their post-pandemic highs. In addition, most stock market valuations are still at unprecedented high level, their PE ratios are substantially higher than the average or even the peak before the pandemic, thus slightly adjustment is not surprise at all.

Past experience – the last Fed's tapering in 2015-2019

In May 2013 when then-Fed Chairman Ben Bernanke suggested that the central bank was considering scaling back asset purchases, US Treasury yields surged as financial markets panicked in what was referred to as a "taper tantrum." "The Fed was in uncharted territory and had never put so much liquidity into the system and so the market was worried about what would happen when the Fed began to taper and tilt more hawkish. In the end, the taper tantrum was unjustified, the economy continued to grow, and the stock market continued to move higher.''

Back to the rate hike in 2015, as the market had certain expectations for rate hikes before it actually implemented, it did not lead to any significant downside to the stock market. However, as shown below, the stock market performance in 2015 and 2016 was still more or less being affected.

US stock market performance

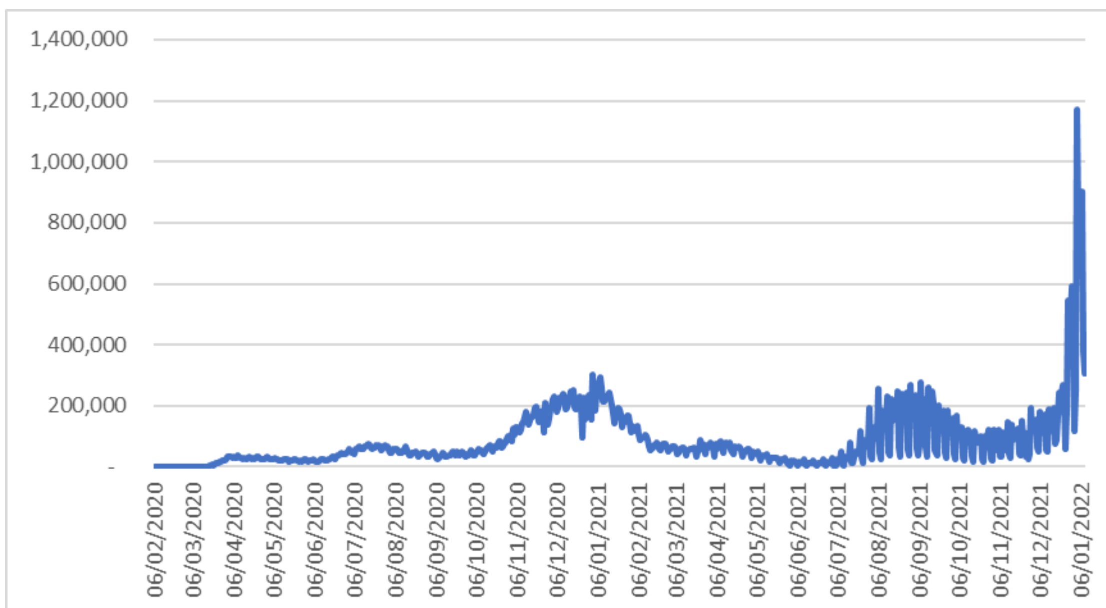
Source: Bloomberg

The PE ratio for S&P 500 – from 2012-2019, the highest was just 23x and the average was just less than

19x, but the current level is about 25x

Source: Bloomberg

The number of confirmed coronavirus cases per day in US has jumped to 500,000 to 1 million per day in recent days, the most severe since the pandemic occurs



Source: Bloomberg

Source: Insider, Bloomberg, WSJ, MarketWatcher, Reuters, SCMP, Financial Times

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