22 February, 2022

Fed likely to have rate hike in March as Powell vows sustained inflation fight

The Federal Open Market Committee had meeting for the first time in 2022 on 25-26 January.

How will the Fed go?

The market attached a great importance to this meeting. Fed’s forecasts in December 2021 signaled that they expected to raise interest rates three times in 2022. However, in Jan 2022, the market had already moved beyond the Fed’s expectation made in Dec 2021 as rate futures already implied the probability of four or more hikes in 2022.

Though the move toward less accommodative policy has been well telegraphed over the past several weeks, markets in recent days have been remarkably choppy as investors worried that the Fed might tighten policy even more than expected.

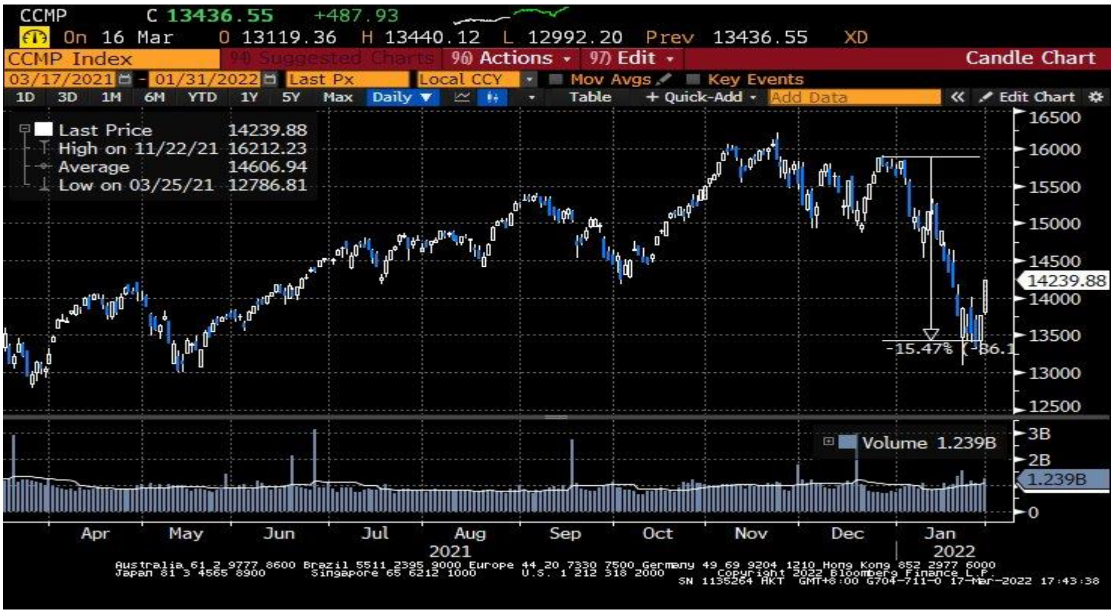
In the Jan’s meeting, the committee’s statement came in response to inflation running at its hottest level in nearly 40 years. The Fed reaffirmed its early plan to end its bond purchases in Mar 2022 in what Powell pledged will be a sustained battle tame inflation. Powell added that Fed could move on an aggressive path.

After the Jan’s meeting, the market still eyed on if the Fed will start raising interest rates in March, and the rate rise will be 0.25% or 0.5%?

As expected, Powell didn’t really specify how will Fed go in the coming meetings. The post-meeting statement just stated that with inflation well above 2 percent and a strong labor market, the Committee expects it will soon be appropriate to raise the target range for the federal funds rate. However, it still did not provide a clear direction whether the Fed will raise rate in March, though indications are that it is highly likely to happen in the March meeting. According to the rate futures, the market has already determined that the Fed will definitely raise rates in March, yet not sure if it will raise rates by 0.25% or 0.5%.

The Fed also sharply raised their expectations for rate hikes this year. Though the Fed did not report any dot pot in the Jan's meeting, according to the recent remarks of Fed officials, coupled with the implied rates hike reflected by the futures market, it is very likely the Fed is debating around four to five rate hikes in 2022, vs. just three as shown in the dot pot reported in Dec 2021.

Nasdaq Composite Index - U.S. gyrated close lower with interest rate sensitive tech stocks weighing most heavily as uncertainties surrounding an increasing hawkish Federal Reserve contributed to the market's churn.



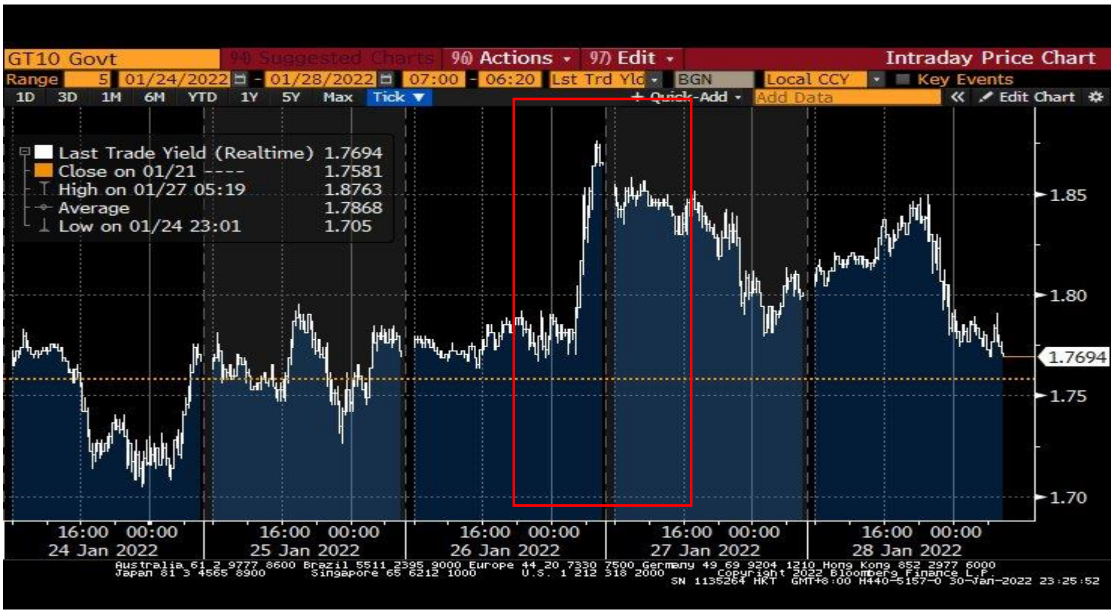
Source: Bloomberg

Another focus is when the Fed will shrink the balance sheet and what is the shrinkage amount

In addition, the committee stated it decided to continue to reduce the monthly pace of its net asset purchases, bringing them to an end in early March. There were no specific indications when the Fed might start to reduce its bond holdings that have bloated its balance sheet to nearly $9 trillion. However, the committee released a statement outlining "principles for reducing the size of the balance sheet." The statement is prefaced with the notion that the Fed is preparing for "significantly reducing" the level of asset holdings. Powell also added subsequent interest rate increases and an eventual reduction in the Fed's asset holdings would follow as needed.

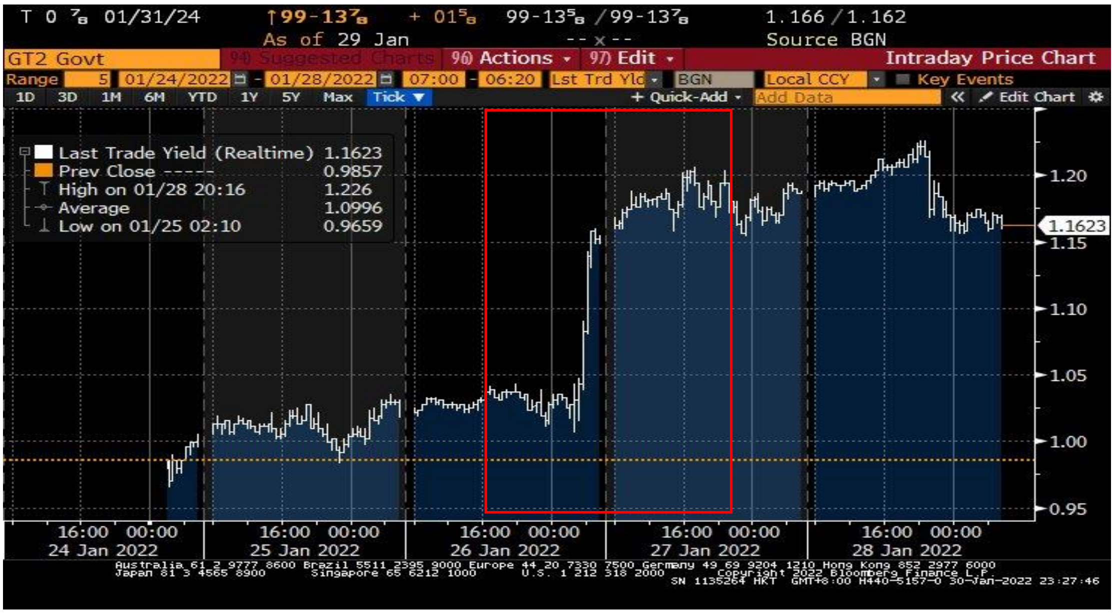
That plan would start after the liftoff in interest rates, the Fed said, without yet setting a specific date, pace or final size. The market expected that the Fed would possibly start to shrink the balance sheet as early as Jun 2022.

US 10-year treasury bond yield rose from 1.76% to 1.87%, sensitive to the Fed's balance sheet policy, rose as Powell signaled a decision would be made soon on when to shrink more than $8 trillion of U.S. government bonds and mortgage-backed securities.



Source: Bloomberg

US 2-Year Treasury Yield rose from 1.03% to 1.15% after FOMC meeting in Jan.



Source: Bloomberg

During the past year, it was very high probability that US stocks were pressured when US bond yields recorded a sharp rise. US stock market tumbled recently over the worries on Powell repeatedly emphasized the economy underlying strength and inflation's persistence, and refused to rule out more aggressive tightening as needed while treasury bond yields rose substantially.

Pink – US 10-year treasury bond yields

Blue - US stocks index

Source: Bloomberg

Source: WSJ, Bloomberg, SCMP, Reuters, The Standard

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For any comments, please send email to us at enquiries@amgwealth.com.

AMG FINANCIAL GROUP
40/F, 118 Connaught Road West, Hong Kong
Telephone: (852) 3970 9531 **Facsimile: (852) 3426 2650**