CURRENT MARKET NEWS

The Fed provides some breathing room

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Thursday, May 5, 2022

What happened?

The Federal Reserve's FOMC ("Federal Open Market Committee") announced a widely expected half percentage point increase in the short-term Fed Funds Rate (to a target range of 0.75 to 1.0%) and also detailed the plans for reducing the size of its balance sheet – the process known as Quantitative Tightening, or "QT". Given that the half percentage point (or, 50 basis point) increase was already expected, the market's attention focused on forward guidance for future interest rate increases and the size and speed of QT.

The market was pleasantly surprised by the Fed's QT announcement given it will start the balance sheet reduction gradually, capped at $47.5 billion per month in combined Treasuries and Mortgage-Backed Securities -- then doubling that amount after three months. While those are big numbers, the Fed was purchasing even more securities than the doubled amount not too long ago. In short, the pace of tightening looks to be more gradual than the pace of easing that prevailed for much of 2020 and 2021.

In terms of future interest rate expectations, the Fed Fund Futures market prior to the Fed's announcement was pricing in a 78% chance of the Fed Funds Rate being 2% to 2.25% by the end of July plus a 22% chance that it would be even higher. Following the Fed's announcement, however, the futures market closed for the day placing zero probability that the Fed Funds Rate would be above 2% by the end of July and an overwhelming probability that it would be 1.75% or below. It was a dramatic shift down in expectations.

Other notable Fed messaging

While the futures market reaction suggested a more dovish leaning, Fed Chairman Powell's press conference struck a balanced tone. He emphasized that recent supply shocks emanating from the war in Ukraine and lockdowns in China could make headline inflation temporarily worse, but that the Fed's focus was more on the "core" components of inflation. At present, Chairman Powell does not see strong signs of a wage-price spiral or unanchored inflation expectations. Additionally, he pushed back against the recent slew of pundits expecting a recession and indicated that the labor market as well as household and business balance sheets were in good condition to weather higher rates. The question of whether the Fed raises interest rates beyond "neutral" and into restrictive range will depend on how financial conditions and inflation evolve.

On net, while there was resolve on the part of the Fed to combat inflation, there were also less aggressive undertones than in recent Fed announcements. On the day, despite geopolitical events driving the price of oil higher, the S&P 500 shot up almost 3%, Treasury yields declined somewhat, and the dollar weakened against major currencies.

Takeaways

The Fed has afforded the markets some breathing room, which should allow the path discussed in our recent April/May Outlook ("Walk the Line") to play out without slamming the brakes on the economy. As Chairman Powell indicated, there is indeed a viable path to a soft landing. Even recent inflation readings have shown signs of leveling off, particularly as measured by the Fed's preferred Core PCE (or, Personal Consumption Expenditures) measure. Nonetheless, uncertainty remains high given the effects of the war in Ukraine, China lockdowns, and the difficult-to-gauge consumer expectations. One big element of risk, however, was that the Fed would once again surprise on the side of hawkishness. In this regard, at least, the Fed has provided some relief.

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C11# 14942460
C11 dtd: 05/04/2022