US: FEDERAL RESERVE SCENARIO 2022

THIS AIN'T YOUR 1980S TIGHTENING

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SUMMARY

- In 2022, we expect the Federal Reserve (Fed) to show increasing concerns about the potential stickiness of inflation and the risk that it spills over into wages and inflation expectations, i.e. worry more about so-called inflation 'second-round effects'. We also expect the Fed to conclude that the US labour market is much tighter than it previously believed.
- The monthly QE will likely need to end faster than the June 2022 date the Fed had initially pencilled in. Recent hawkish comments from Chairman Jerome Powell seem to vindicate this scenario.
- We think the first Fed rate hike could come relatively shortly after the Fed has brought forward the end of monthly asset purchases – possibly in June 2022. We expect one rate hike per quarter between June 2022 and mid-2023, i.e. five rate hikes in total.
- But we think the Fed – and especially the Powell Fed – remains highly sensitive to financial markets, so we think it is more likely that it will halt rate increases at some stage than accelerate their pace.
- In the long run, we think the Fed will not want to move interest rates above its 2% inflation target – in essence, inflation-adjusted Fed interest rates will stay negative for a while. We also think the Fed will be patient before shrinking its enormous balance sheet.
- Structurally, we believe the Fed is in a 'debt dominance' monetary policy regime. In other words, we think its overarching (if unstated) priority is to prolong the business cycle and strive to avoid a debt-driven recession. Since such a regime means maintaining interest rates structurally low, and one might wonder whether the Fed has not painted itself into a corner.
- There are potential hidden costs to structurally hyper-stimulative monetary policies, especially the side-effect of ever-rising debt (and the harm done to 'risk-free' savings as a public good). But the Fed will likely continue to prioritise short-term benefits above long-term financial risks and other economic distortions.
- There are risks around our scenario of three hikes in 2022. In an alternative positive scenario, the Fed could continue with QE until June 2022 and refrain from hiking rates at that point— for instance, if it felt the coronavirus was still having sizeable repercussions on the economy and it shifted back to preserve growth over the inflation risk.
- In an alternative negative scenario, there could be a sharp pick-up in the Fed's own inflation-expectation indicators (which are very much fashioned by the bond market and not really the 'real economy') leading to more aggressive monetary tightening. Such surprise sizeable tightening would be reminiscent of what the Fed did when Paul Volcker was Fed chairman in the early 1980s to restore inflation credibility. But we would assign a low probability to such 'Volcker 2.0' scenario, especially during Jerome Powell's tenure.

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The Fed doves leave their nest in 2022, but they'll be back

In a nutshell, we don't think that the removal of monetary accommodation we expect in 2022, and that the Fed has increasingly been hinting at in recent weeks, changes anything to our belief that we will remain **entrenched in the same 'soft-money' era** we have been in since the 1990s.

Let's recap this soft-money era in a few important milestones: The Fed started quantitative easing (QE) after the global financial crisis, and QE subsequently endured for several years. Most recently, **QE re-started it in 2020 in response to the coronavirus shock**, sending the balance sheet to USD 8.7 trillion as of end-November 2021, from USD 4.2 trillion in December 2019. Chairman Powell's bold and creative policy response to the coronavirus shock, which included once-unthinkable moves such as buying 'junk' corporate debt, probably contributed to his re-nomination as Fed chairman in November 2021 for another four-year term.

In other words, **we will only see a partial 'normalisation' of Fed policy in 2022,** in our view. **In 2023, we think rate hikes could stop**. To summarise, the Fed may become in 2022 slightly less generous after a long period of monetary largesse—but the underlying regime will not change.

More specifically, **we believe the Federal Reserve is in a 'debt dominance' monetary regime** since the global financial crisis: its actions are tightly constrained by the high (and growing) levels of debt in the US economy. In fact, one major focus of the Fed in this regime is **high corporate debt**, which could tip the US economy into recession if borrowing costs were jacked up suddenly. And we think it is in the Fed's DNA to do all it can to avoid another recession like 2008: 'first, do no harm' [to the macro cycle] is the implicit Fed motto.

Also, despite its proclaimed political 'independence', the Fed has to pay attention to the **federal government's borrowing costs**, although we do not think this is the main priority (…yet).

We think the official Fed monetary strategy of 'flexible average inflation targeting', under which a slight inflation overshoot is welcome to compensate for low past inflation, unveiled in August 2020, is only a façade. By the way, this strategy may already need to be re-visited, since it has been overtaken by recent inflation developments. High inflation may be now more of a risk than low inflation, something that Powell had not envisaged when unveiling the official strategy revamp. In the end, **the key word in the Fed's official strategy may be "flexible" and not "average inflation",** because the Fed wants to keep its high margin of manoeuvre instead of adhering to a strict policy rule based on a few set parameters, such as the Taylor Rule or its variants.

We expect three Fed rate hikes in 2022

Nonetheless, we believe the Fed will **pay more attention to accelerating inflation** next year, especially if more data emerges showing the job market is becoming even tighter. In 2022, the Fed will look closely at the ratio of job openings to unemployment, and wage growth data, in our view. We think the Fed will **accelerate the winding down of its asset purchases (ie, QE)**, in line with broad hints from Powell during congressional testimony on 30 November. We think the end of QE will open the way for a 25 basis point rate hike

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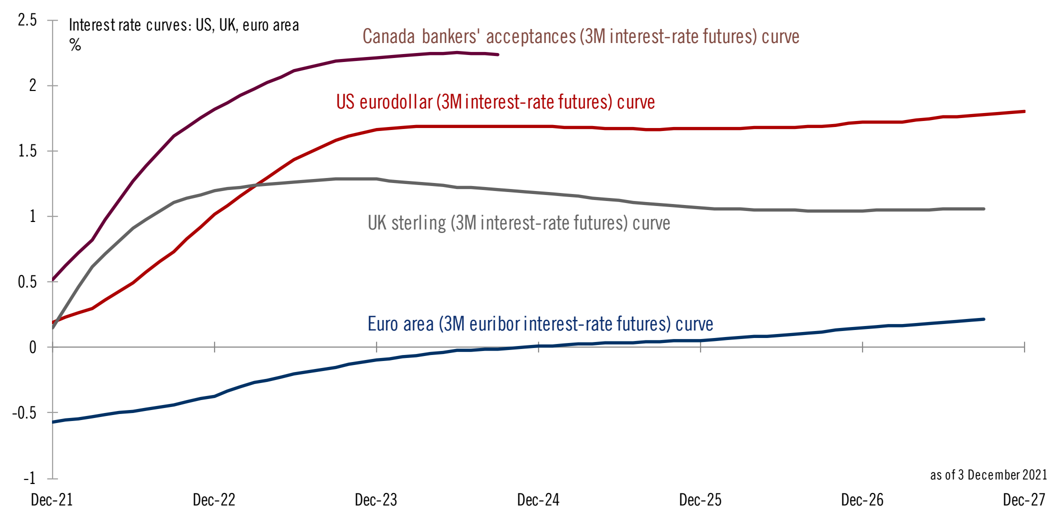
as soon as **June 2022**. Our year-end 2022 fed funds rate target forecast is 0.75-1.00%. Our year-end 2023 forecast is 1.25%-1.50%. By comparison, the fed funds future market is pricing an effective fed funds rate of 0.64% by December 2022 (as of 3 December 2021).

Two risks hang over this scenario, both centred around the **direction of market-based inflation expectations**, which the Fed scrutinises closely. The first risk is that the Fed worries more about the lingering impact of the coronavirus on the economy as inflation expectations slip, and the Fed walks back its rhetoric about accelerating QE taper; this would keep the first rate hike at bay.

The second risk, or negative scenario, is that **sharply-accelerating wage inflation** sparks a wage-price spiral, and a big rise in inflation expectations, including market-based measures tracked by the Fed. In that case, the Fed may need to reassert its credibility more firmly by hiking rates more than predicted. However, we still think the Fed will weigh any such moves against the potential costs to economic growth and the risk of destabilizing debt markets. We think that preserving growth, and avoiding recession, counts more for the Fed than inflation credibility. While he may have started to sound more hawkish lately, we believe **Chairman Powell is still intrinsically more worried the US falls into a period of Japan-like stagnation in the longer run** than about a revival of 1970s-style inflation. Such 'Japanification' risk was already the main underlying worry of Chairman Ben Bernanke in the 2000s.

MARKET-BASED EXPECTATIONS FOR SHORT-TERM INTEREST RATES (BASED ON FUTURES)



Source: PWM - AA&MR, Bloomberg (3 December 2021)

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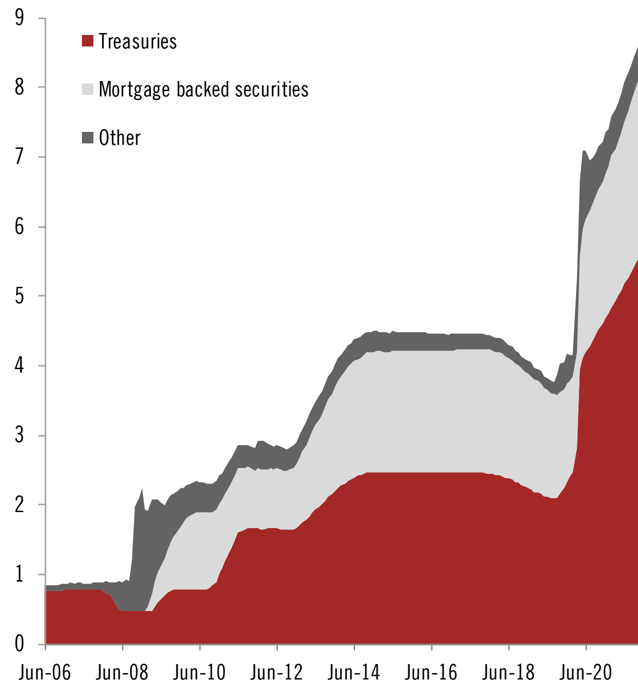
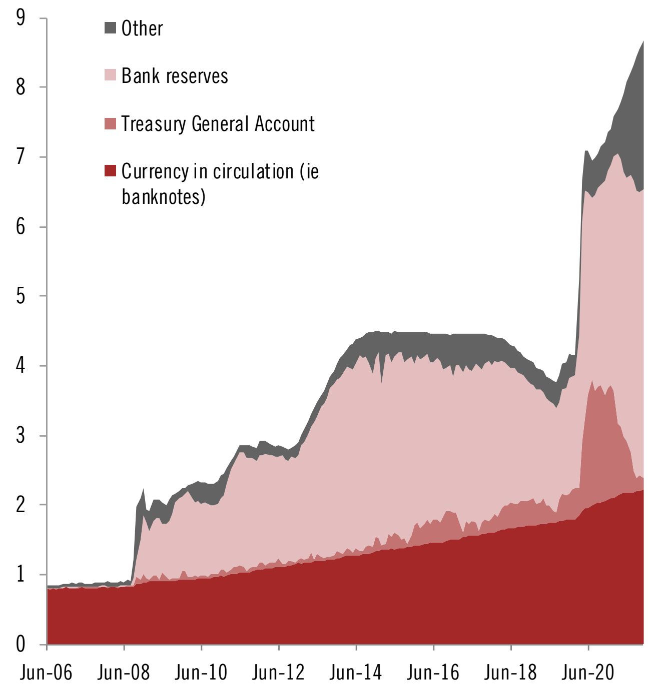
FED ASSETS (USD TRILLION)



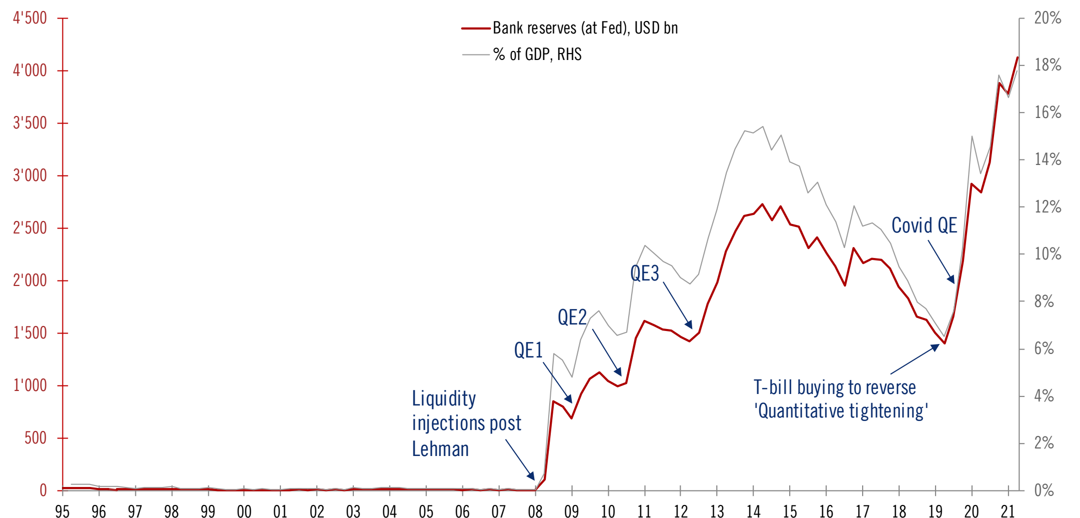
Source: PWM - AA&MR, Bloomberg (Nov. 2021)

FED LIABILITIES (USD TRILLION)



Source: PWM - AA&MR, Bloomberg (Nov. 2021)

A SHORT HISTORY OF FED LIQUIDITY INJECTIONS (QUARTERLY DATA): BANK RESERVES IN USD BILLION



Source: PWM - AA&MR, Bloomberg (3 December 2021)

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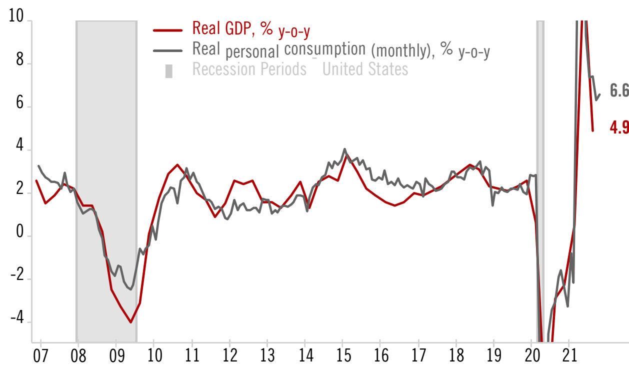
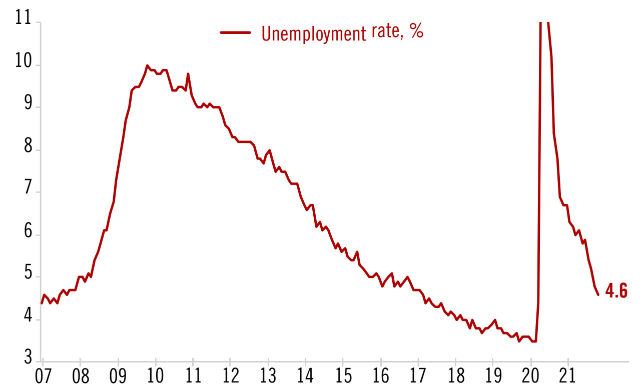
REAL GDP AND PRIVATE CONSUMPTION GROWTH, % Y-O-Y



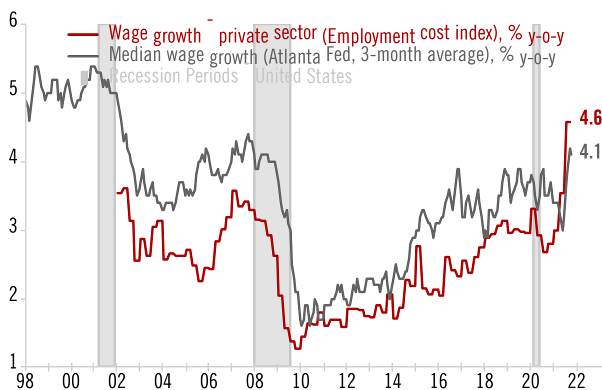
Source: Pictet WM – AA&MR, Factset

UNEMPLOYMENT RATE, %



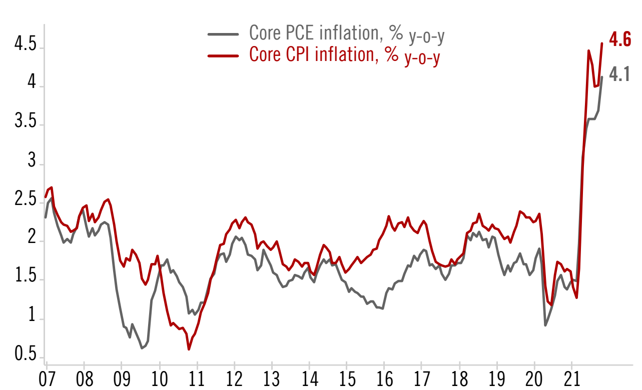
Source: Pictet WM – AA&MR, Factset

WAGE GROWTH INDICATORS, % Y-O-Y



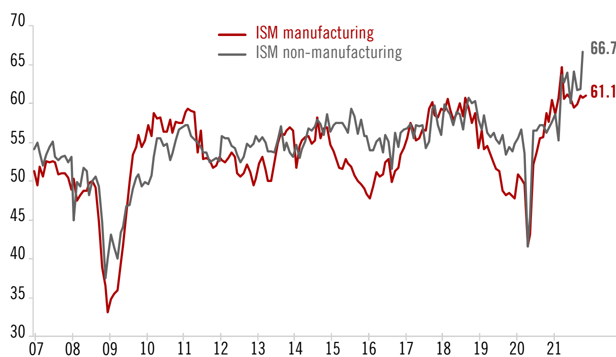
Source: Pictet WM – AA&MR, Factset

CORE INFLATION (PCE AND CPI), % Y-O-Y



Source: Pictet WM – AA&MR, Factset

ISM BUSINESS SURVEYS



Source: Pictet WM – AA&MR, Factset

HIGH-YIELD CORPORATE BOND SPREAD, BASIS POINTS

Source: Pictet WM – AA&MR, Factset (last close)

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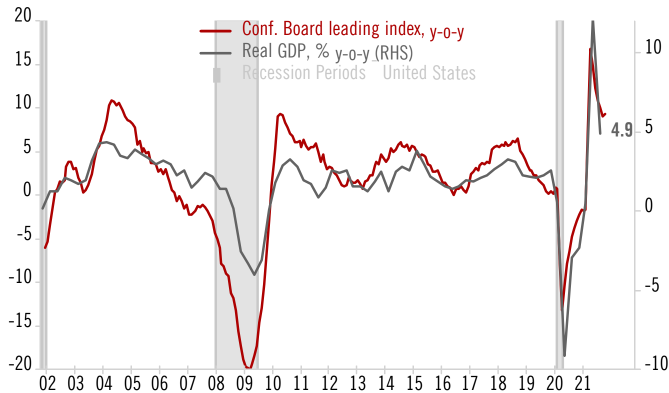
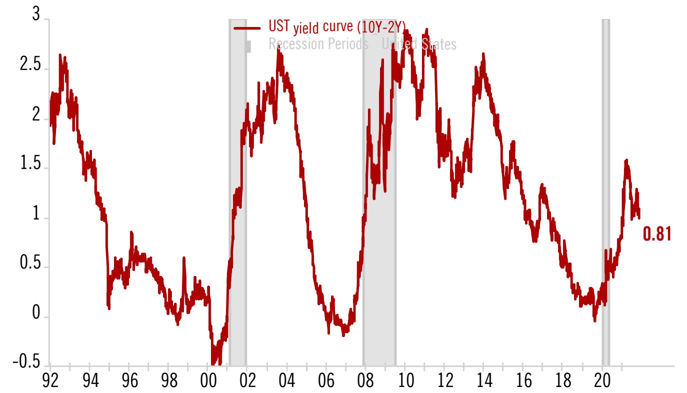
CONF. BOARD LEADING INDEX, % Y-O-Y VS GDP GROWTH, % Y-O-Y



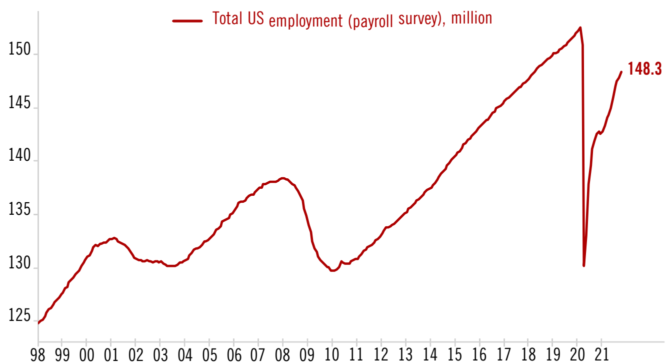
Source: PWM - AA&MR, Factset

US YIELD CURVE SPREAD (10-YEAR YIELD MINUS 2-YEAR YIELD)



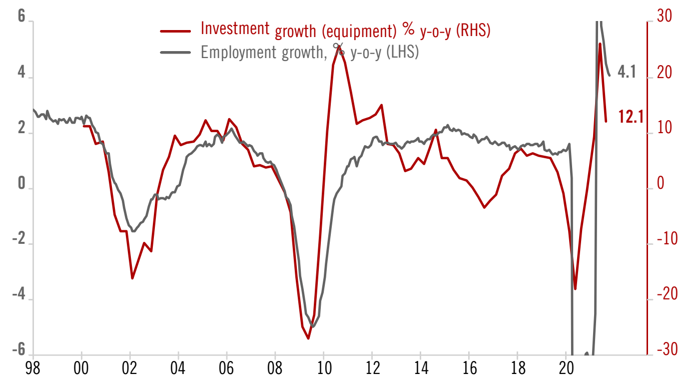
Source: PWM - AA&MR, Factset (last close)

TOTAL US EMPLOYMENT



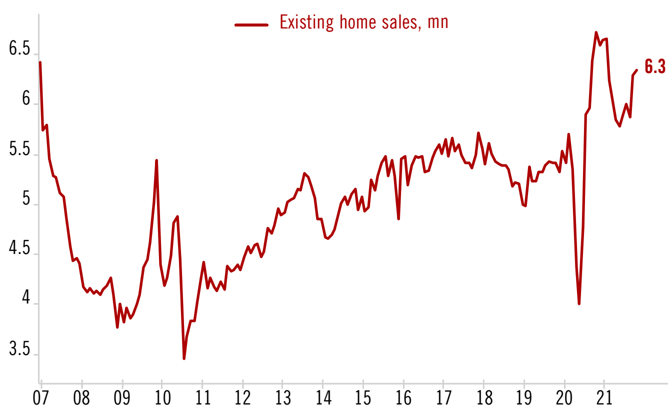
Source: PWM - AA&MR, Factset

US INVESTMENT (EQUIPMENT) VS EMPLOYMENT GROWTH, % Y-O-Y



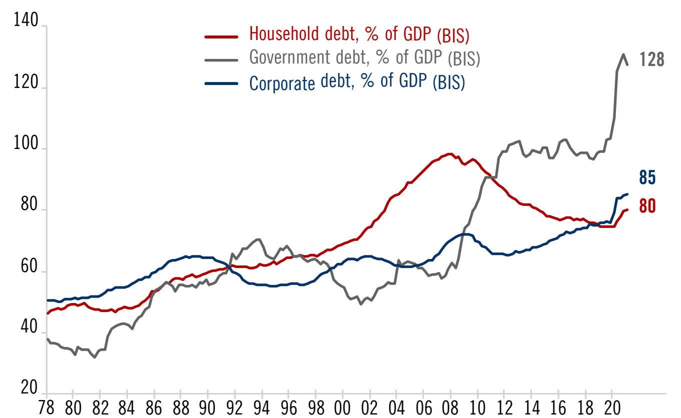
Source: PWM - AA&MR, Factset

EXISTING HOME SALES, MILLION UNITS (ANNUALISED)



Source: PWM - AA&MR, Factset

DEBT RATIOS (HOUSEHOLD, CORPORATE, GOVERNMENT), % OF GDP



Source: PWM - AA&MR, Factset

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