GENERALI INVESTMENTS

Focal Point

Fed's normalisation path not fully priced yet

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Our Focal Point series explores topical issues on macro, markets and investment

- The Fed's recent hawkish pivot has left markets puzzled about the speed of looming monetary tightening. We think that the US economy can withstand at least four rate hikes this year and a total of eight between now and mid-2024. Balance sheet reduction is likely to start in the summer and end no later than in mid-2025.
- Upside risks for inflation and of an even more aggressive stance remain and are confirmed by the most recent wage data, but speedy tightening may undermine growth and force the Fed into a U-turn.
- US Treasury yields have already sold off across the curve, but a further bear-flattening of the US curve is in the offing. A further upside repricing of the terminal key rate and the forthcoming balance sheet reduction will support a moderate rise on long yields, while the incipient key rate cycle will trigger a stronger upward shift of the short end of the curve.

In the January meeting, the Fed proved more optimistic than expected on the economy and surprisingly hawkish in its determination to reduce fast its monetary stimulus to stem inflation. Even though Fed officials had telegraphed their hawkish pivot earlier, markets were caught by surprise. Over the coming months the tension between what the Fed deems necessary to remove support and how much financial markets can tolerate will be a crucial theme. In this Focal Point, we briefly recap our view on the Fed's next steps, which include at least four hikes this year and the beginning of a rather fast balance sheet reduction, with a distinct possibility of a further hike. Yet the shallow path for the expected fed fund rates expressed by markets, highlights that the Fed's hawkishness has significantly increased the possibility that tightening will prove ultimately excessive and might trigger a U-turn like 2019. Despite these risks, the path to a further rise in bond yields is marked out. Over time, particularly short-dated yields have leeway to raise more.

The Fed aims at a fast normalisation …

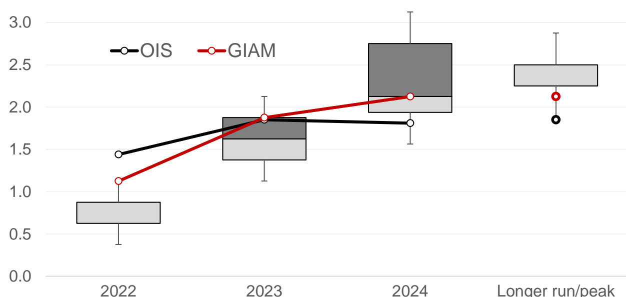
At the January meeting chair Powell stressed that the current situation is very different from the period immediately preceding the December 2015 lift-off, as the economy is in a much stronger position. This is especially the case for the labour market. With less than two unemployed for every three vacancies, Powell reckoned, the economy can withstand the tighter financial conditions needed to cool down demand and tame inflation. The evidence released since the meeting confirms the worries on inflation, with core PCE (the Fed's preferred measure) up to 4.9% in December, more than twice the target rate More inflation can be in the pipeline: in Q4 the employment cost index rose by 4% yoy,

lower than expected but still the strongest reading in three decades. Data on activity are more reassuring, especially after the strong showing of January employment, but high inflation is depressing consumer mood: in December real consumption was down 1% dragged down by goods. Economic surprises have deteriorated since December and nowcasts point to barely positive growth in Q1. Yet the Fed's communication at and after the January meeting barely mentioned the downside risks to growth. It believes that the current weakness is just an air pocket due to the Omicron wave and supply bottlenecks: activity will recover strongly in Q2. We tend to agree, but the recent case of inflation shows how hard it is to time when temporary disruptions end.

Chair Powell stressed that the Fed will be "nimble" and highly data driven; the flip side is that the path of normalisation will be very uncertain. Still, our baseline sees a total of four hikes this year. Delivering on the hawkish narrative will lead to hikes in March and May, with a pause in June for the announcement of quantitative tightening and then action in September and December. Frontloading the rate tightening will allow space for a more aggressive stance (i.e., an additional hike in June or July) should inflation require it, while in the second half of the year, more spaced hikes will be needed to have the opportunity to assess the impact on the economy, given the forecast of moderating inflation. Powell and, subsequently Atlanta Fed governor Bostic (who usually leans dovish) have not ruled out 50bps hikes. We deem them unlikely mostly because of their uncertain impact on financial conditions. We expect the cycle to consist of a total of eight hikes, ending by mid-2024 in our baseline. This is a slightly less ambitious path than the one foreseen by the FOMC in December, as we think that the policy rate will peak at 2.1%, just below the committee's estimate of the equilibrium rate (2.5%), but still some 30 bps higher than what markets is currently pricing. The level projected by the FOMC reflects the real equilibrium rate (r-star) slightly increasing from the current near zero level and inflation anchored at or just above 2%. We do expect a rise in r-star as productivity lifts the economy's trend growth and acknowledge that inflation may remain higher than in previous cycles.

Distribution of the FOMC "dots" and Fed fund rates forecasts

Year-end, extremes and quartiles of the dots distribution



Source:Federal Reserve Board, Datastream,GIAM estimates

Still, the high level of (private and public) debt, will work as a sort of brake against too high a peak in the policy rate. In late 2015, at the time of the previous lift off the Fed estimated a 3.5% equilibrium rate. It was gradually scaled down as rate hikes proceeded, to 2.8% at the end of 2018, when the actual fed funds rate peaked at 2.4%.

Balance sheet reduction should be more predictable. Chair Powell stated that at least two FOMC meetings will be needed to define the details, but he implied that the process would begin earlier and be faster than in 2017. Therefore, we expect Quantitative Tightening (QT) to start in July. After a slow start and three months of ramping up, we forecast that the Fed will cease to reinvest around US$ 60 bn of treasuries per month and up to US$ 40bn of MBS, (roughly twice as fast as in the previous QT); moreover, it will reduce to zero its T-bills holding by the beginning of 2023. The endpoint will depend on the Fed's estimate of the level of reserves consistent with the smooth implementation of monetary policy, which is hard to gauge. Squeezing back the balance sheet to where it was at the end of 2019, i.e., from the current 36% of GDP to 19.5%, or from US$ 8.9tn to around US$5.5tn, could be achieved by Q2 2025. But we see this as a lower bound; financial stability concerns may prompt the Fed to hold a higher level of reserves than in the past, requiring correspondingly bigger asset holdings. In this case QT could end sooner. Studies carried out by the Fed estimate that a US$ 650 to US$ 675 bn reduction has the same effect as a 25bps rate hike. Therefore, under our baseline scenario, between this summer and the end of 2023 the projected 9% of GDP reduction would add the equivalent of roughly 2.5 rate hikes to monetary tightening.

Projected path for the Fed's balance sheet

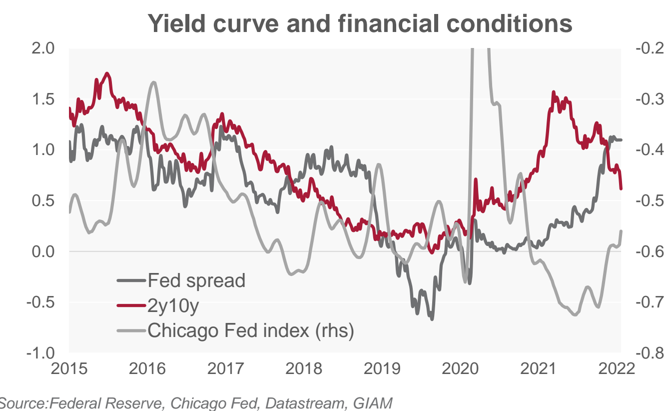
	US$ bn	% GDP	25bps hike equivalent
Q2 2022	8,850	36%	-
Q4 2022	8,300	33%	0.8
Q4 2023	7,090	27%	2.6

…and risks are still tilted to more tightening

Higher and more persistent inflation remains the most relevant risk. A deceleration in wages is unlikely soon; of the easing of the supply bottlenecks and the moderation in shelter price inflation will also be very progressive. The Fed wording reflected this balance of risks, and we interpret the mentioning of a 50bps lift-off as a reminder that every tool can be used. A tighter monetary policy would be implemented via an even more frontloaded path of increases, with five or six hikes this year and the rest stretched over a long period to ensure a soft landing. In line with the Fed's plan, the hawkish policy twist has already started to affect financial conditions. The index developed by

the Chicago Fed has tightened significantly and is now back to the level prevailing just before the pandemic, even if still well below its long-term average. Information from the yield curve does not look worrying: the most popular measure, the 2y10y spread has nosedived but remains positive. An alternative, the spread between the six quarter ahead three months forward and the three-month T-bill rate, advertised by the Fed as a better predictor of recessions[1], has indeed steepened after the Fed's hawkish pivot.

Still, US growth will face headwinds, especially in the second half of this year. First, the fiscal impulse to growth will turn negative, even more so since the Biden administration's fiscal plan is stuck in the Senate. Secondly, the strong Q4 2021 GDP print was driven to a large extent by restocking, possibly hinting at a slowdown in the underlying trend for domestic demand. This may turn out not to be as temporary as the Fed expects. Therefore, the policy-induced demand slowdown needed to cool down inflation may hit a weaker than estimated economy.



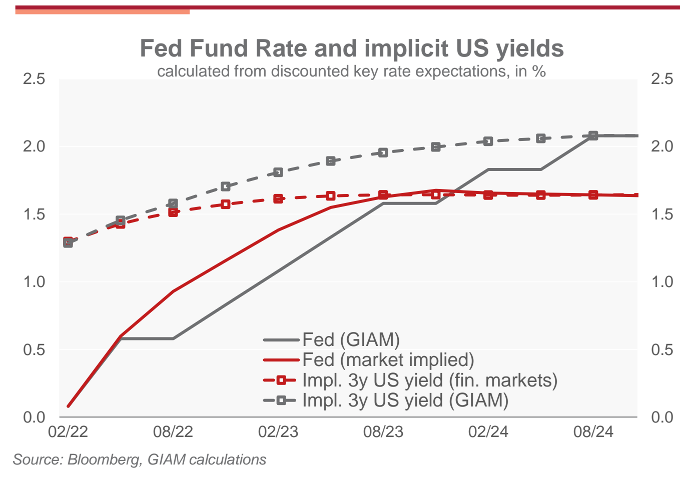
Source:Federal Reserve, Chicago Fed, Datastream, GIAM

Such an alternative scenario has a much lower probability than that of stronger inflation. Still the more aggressive stance advertised by the Fed almost mechanically increases the risk of a hawkish policy mistake. Over the coming weeks, new data on economic activity will not help much as it will be distorted by the Omicron variant and global supply disruption, providing a still blurred picture of the state of the economy just before the lift-off.

Weakness of US Treasuries to continue

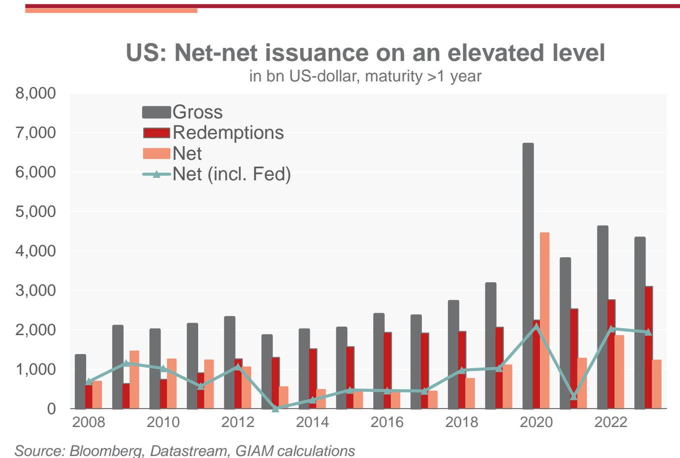
Since the end of November, the expected 2022-end level of the Fed key rate has shifted upwards by around 70 bps. The pricing of five key rate hikes has triggered a sell-off of Treasuries across the curve and the 2-yr/10-yr gap decreased by about 40 bps to around 60 bps. Nevertheless, we expect the trends to continue even further.

Forthcoming key rate hikes will pave the way to a further increase in short-dated yields (see chart). But as financial markets expect the Fed to hike less than seven times (each 25 bps) during the cycle, our expectation of the cycle continuing until 2024 implies a stronger increase in H2 2022. We forecast 2-year US yields to rise to 1.80% by the end of the year. This means a further increase of 50 bps from the current level. What is more, the priced termination of the cycle implies that financial markets expect only a moderate further increase in 2023. In contrast, we consider a further rise of 2-year yields above 2% in 2023 to be likely.



Source: Bloomberg, GIAM calculations

The development of longer-dated US yields is less linked to the near-term path of key rates but much more dependent on the forecast terminal key rate. The correlation coefficient between 5y1m forward cash and 10-year yields over the past year is almost 0.75. Although financial markets have corrected terminal key rate expectations upwards, they are still stuck slightly above 1.75%. As outlined above, given the tight labour market and the persistent inflation pressure we regard this as too cautious and see scope for a further upward adjustment triggering higher long-dated yields.



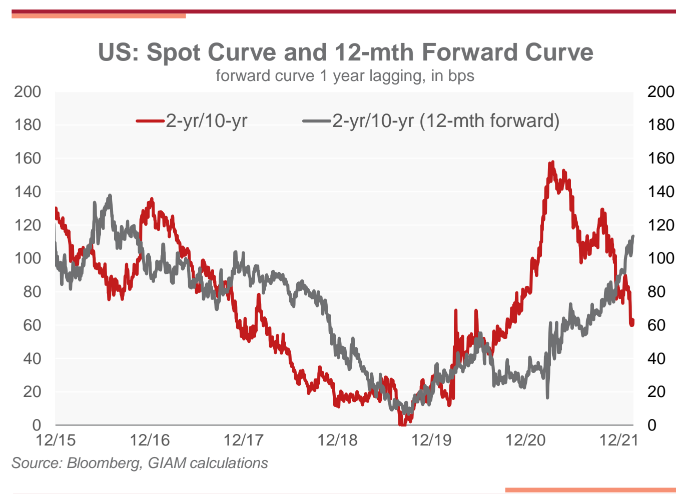
Source: Bloomberg, Datastream, GIAM calculations

Moreover, QT will impact the net-net supply (i.e., after Fed

1 See here. This spread can be seen as the market's expectation on the policy rate in the near term and is not affected by distorting factors like term or liquidity premia. For this reason, it performs better in predicting recessions.

action) of US Treasuries significantly. The effect of QT is much more pronounced at the long end of the curve. Although net supply will come down from its Covid-19 related high levels in the years to come (although particularly forecasts for 2023 are still rather uncertain) net-net supply is forecast to remain on an elevated level (see chart above). As we expect QT to last until 2025 the technical situation will remain tight in the years to come.

Accordingly, in our base scenario we forecast 10-yr US yields to rise above 2% throughout 2022 and to finish the year at around 2.2%. Risks are biased to the upside, but asset valuation and debt sustainability depend on low (real) yields. Hence, there is a self-correcting mechanism that is likely to prevent a too strong yield increase.



Source: Bloomberg, GIAM calculations

As a result, we forecast the 2-yr/10-yr curve to flatten to around 40 bps which is a moderately higher level than forwards are pricing (flattening to around 25 bps currently discounted). It is quite common for the yield curve to flatten not only before the cycle begins, but also after it has started. However, forwards are not necessarily a reliable indicator of the coming trend. Comparing the spot curve with the 12-mth forward curve 12 months earlier shows that sometimes they overestimate and at other times underestimate the actual development. E.g., the 2-yr/10-yr gap was around 130 bps at the beginning of the last cycle in December 2015 (after a significant flattening in the run up to the decision). At that time forwards priced a further flattening to around 90 bps until December 2016. In fact, the steepness hardly changed in the first year after the start of the cycle and only later did a forceful flattening set in. Hence, for the time being we do not assume an inversion of the 2-yr/10-yr curve over the course of the year.

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