

FED MEETING PREVIEW - JANUARY 2022

PREPARING MINDS FOR A MARCH RATE HIKE

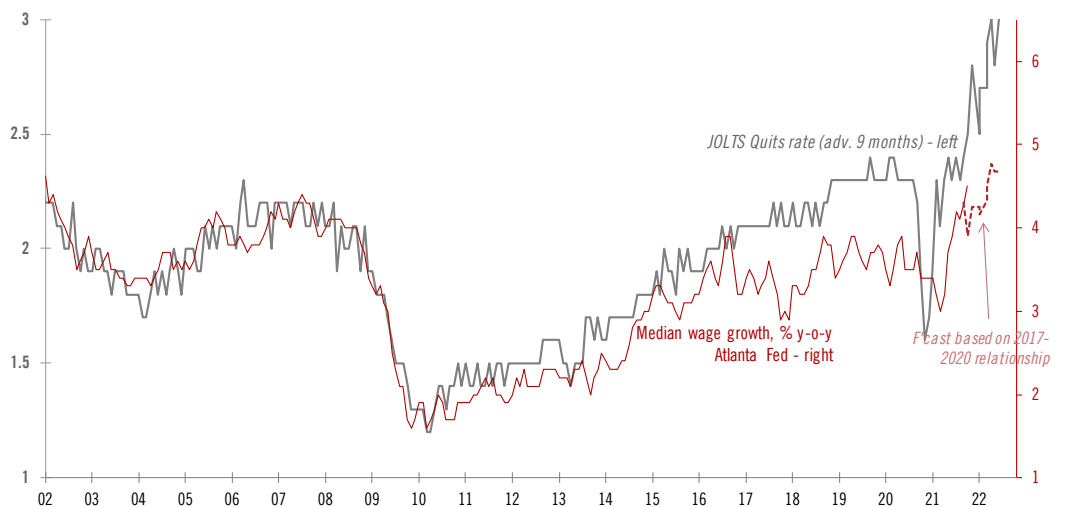
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SUMMARY

- > At the end of its 25-26 January meeting, the Federal Reserve is likely to signal its intention to hike rates at the next Federal Open Market Committee (FOMC) meeting in March.
- > The Fed seems disorientated by persistently high monthly inflation prints and a tight labour market. Calls are growing within its leadership to accelerate monetary tightening.
- > A surprise at the January meeting would be to see the Fed abruptly calling an end to its monthly bond purchase programme, currently scheduled to end in March.
- > The post-meeting press conference will be monitored for signals about the timing and potential extent of the future balance-sheet runoff.
- > The Omicron variant could have a net inflationary effect due to additional supply-chain disruptions (and a limited hit to consumer demand). Fed anxiety could remain high in the coming weeks as data percolate.

CHART 1: THE HIGH LABOUR-MARKET 'QUITS RATE' IS MAKING THE FEDERAL RESERVE ESPECIALLY ANXIOUS



Source: PWM - AA&MR, Bloomberg (January 2022)

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Preparing for a March rate hike

There has undoubtedly been a sizeable **'hawkish pivot' at the Federal Reserve** since December, coinciding with Jerome Powell's **re-appointment as Fed Chairman**. Powell has been given the explicit mandate by president Biden to curb high inflation (which could be a political issue for the Democrats going into the November midterms) as economic data show persistently high inflation, driven by goods, and a very tight labour market.

The December unemployment rate fell to 3.9%, while the Atlanta Fed median wage growth print for the same month accelerated to 4.5% year-on-year (y-o-y). At the December FOMC meeting, during which the Fed moved forward the end of its monthly bond purchase programme from June to March 2022, Powell expressed his surprise about high wage growth, which the Fed tracks closely because of the potential spillovers into inflation more generally.

Subsequently, the minutes of that meeting as well as the Senate testimonies of Jerome Powell and Lael Brainard (Biden's nominee to be vice-chair of the Fed) revealed that the Fed was having **active internal discussions about reducing its balance sheet**, with a decision likely before year's end, according to Powell.

The **Omicron variant can only amplify the Fed's concerns** about the potential build-up of inflation, especially as the Fed has tended in recent weeks to be very much backward looking rather than forward looking. In other words, the Fed seems to be concentrating on what is happening in the US economy right now rather than on what will come once Omicron fades. There are signs that Omicron is having a sizeable impact on labour markets through an increase in work absences. This could add fuel to the fire when it comes to wage growth, especially in low-income, services industries where jobs cannot be done from home on a computer.

Meanwhile, supply-chain disruptions may keep goods price inflation elevated; continued logistical issues at several US ports is not a good omen for merchandise inflation in coming weeks. The ongoing robustness in commodity prices, including food prices, is the icing on the inflation cake.

Judging from recent speeches by Fed officials, the **central bank seems to believe that it needs to act more forcefully**. At the same time, the Fed has long sought to avoid "rocking the boat" and has not wanted to shock markets in particular. There is now rising tension between the need to react to rising inflation on the one hand and still have gradualist approach to rate tightening and look serene on the other. It will be interesting to see what the Fed decides about quantitative easing (QE). Although at a progressively reduced rate, the Fed is indeed still buying bonds each month – until March. But **it could decide to end its monthly purchases before then if it is really intent on shrinking its balance sheet early**. By contrast the "gradualist" approach would call for letting QE end as initially scheduled, in March.

Decisions about QE may inform the debate about the size and pace of Fed rate hikes: Should they remain at a pedestrian pace of 25bps per quarter (our main scenario) or should the Fed shift gears and hike the Fed funds rate by 50bps per quarter, or even 50bps at a single meeting (the Federal Reserve meets twice per quarter). **The last 50bps rate hike dates back to May 2000** at a time when the Fed, then led by Alan Greenspan,

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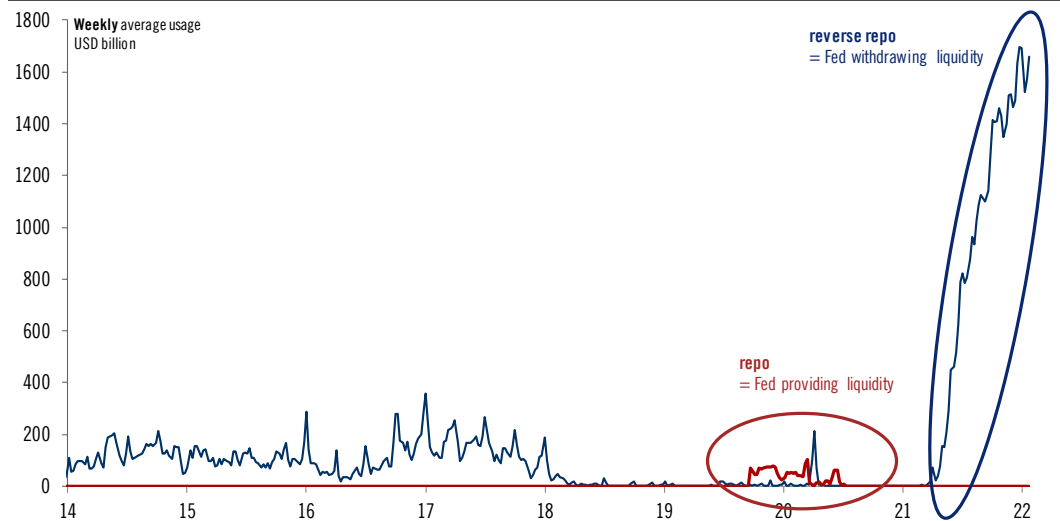
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worried that high asset prices risked boosting demand too much and nurturing inflationary pressures further down the line. We do not think the current Fed overall has reached this point in its reflections, although a few members of the FOMC may be heading that way.

Bottom line, we think the Fed will indicate that a 25 bps rate hike is coming at its March meeting, with a 40% probability that QE is ended in February instead of March. In 2022, we think the Fed will stick to a **predictable, gradualist approach to rate hikes**. We also think that the Fed's balance sheet shrinkage will remain passive—in other words, bonds will just be let mature rather than actively sold; and with some monthly caps to avoid too-large redemptions.

In the long run, we believe the Fed will be judged not by its ability to move rates up but by its capacity to avoid having to cut nominal rates all the way back to zero again and restart QE when the first external shock hits in the coming years. This is far from being assured.

CHART 2: MUCH OF THE RECENT LIQUIDITY ADDITIONS IS 'RETURNING' TO THE FED VIA REVERSE REPOS

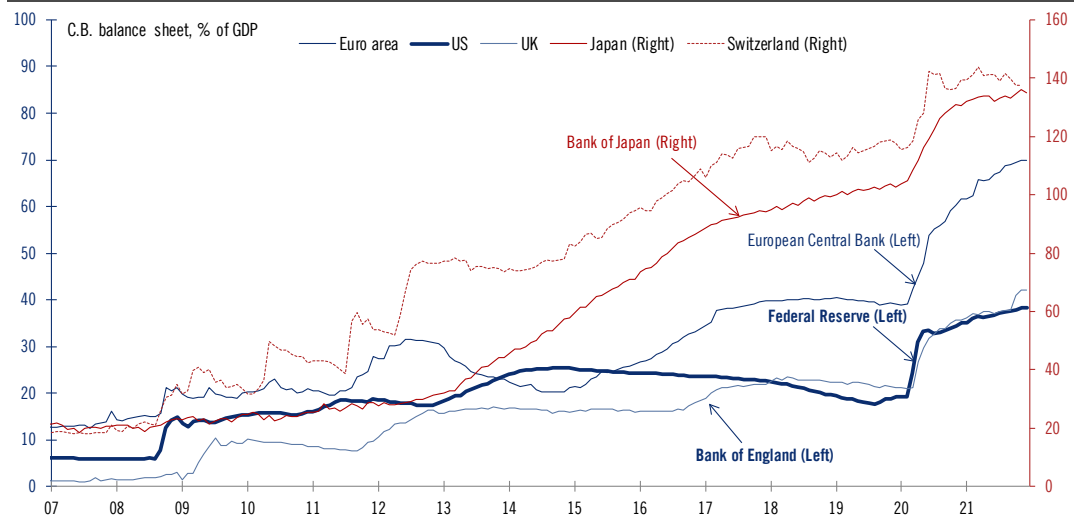


Source: PWM - AA&MR, Bloomberg (as of 24 January 2022)

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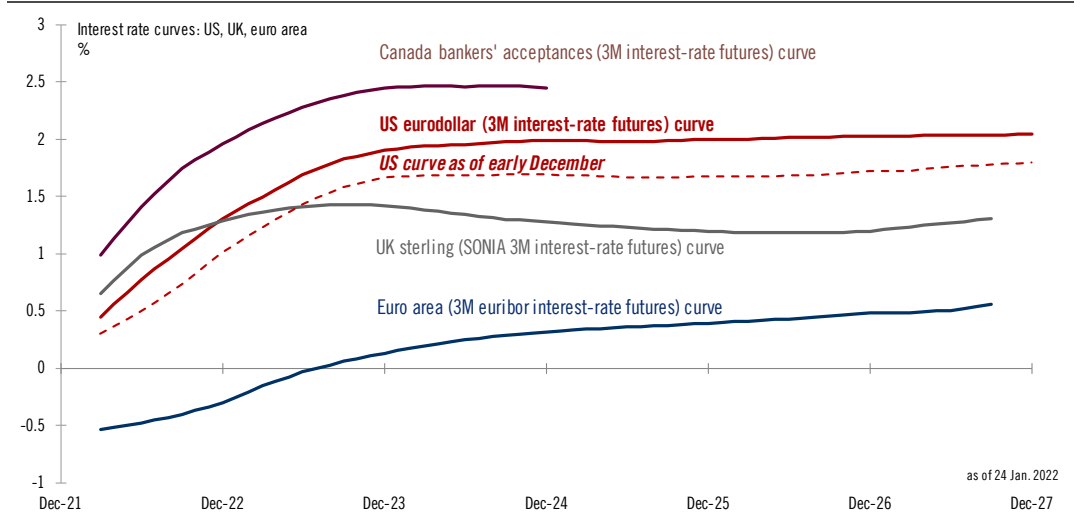
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CHART 3: THE FED'S BALANCE SHEET GREW STRONGLY, BUT STILL LESS THAN AT SOME OF THE FED'S PEERS



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

CHART 4: MONEY MARKETS EXPECT THE FED TO STOP RAISING RATES BELOW 'NEUTRAL' (2.5%)

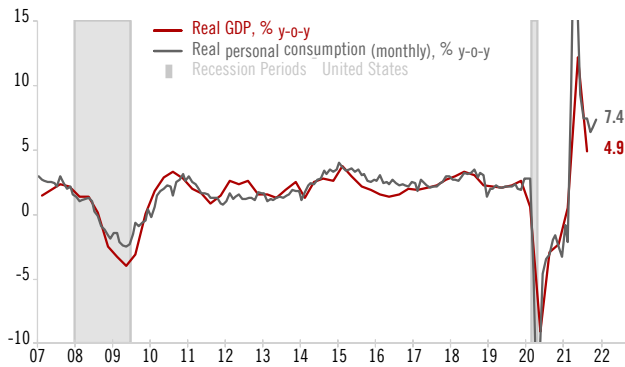


Source: PWM - AA&MR, Bloomberg (as of 24 January 2022)

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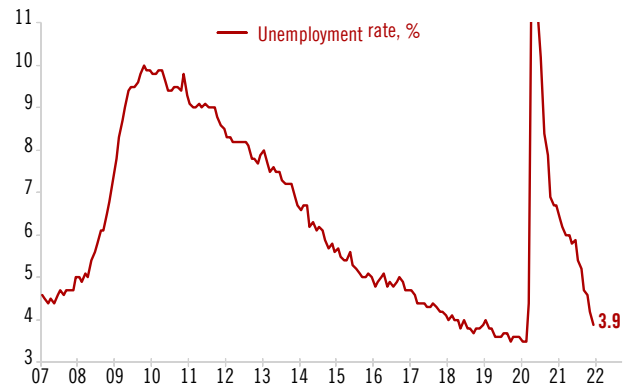
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REAL GDP AND PRIVATE CONSUMPTION GROWTH, % Y-O-Y



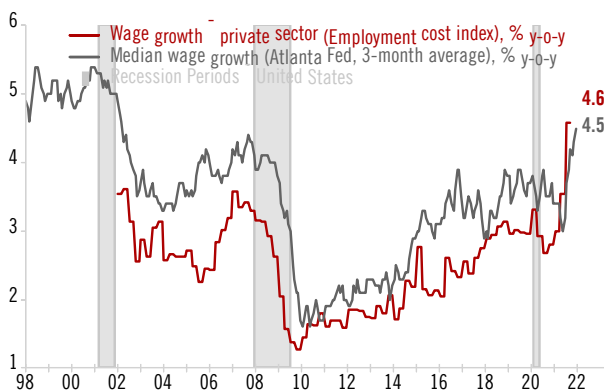
Source: Pictet WM – AA&MR, Factset

UNEMPLOYMENT RATE, %



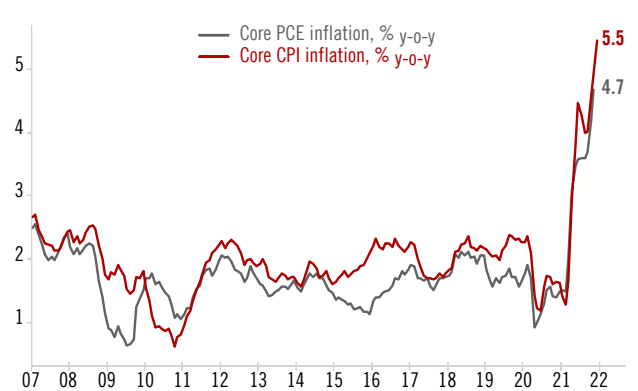
Source: Pictet WM – AA&MR, Factset

WAGE GROWTH INDICATORS, % Y-O-Y



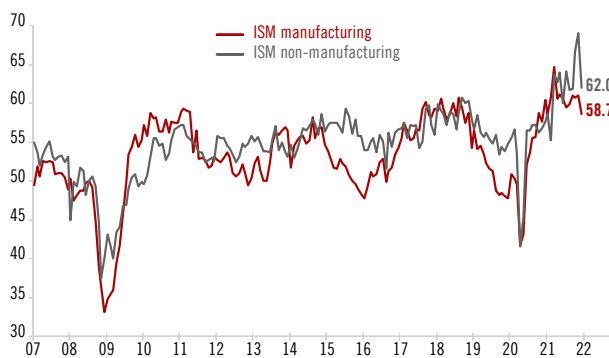
Source: Pictet WM – AA&MR, Factset

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



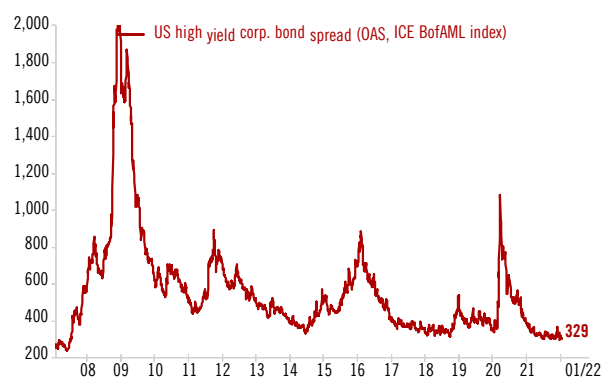
Source: Pictet WM – AA&MR, Factset

ISM BUSINESS SURVEYS



Source: Pictet WM – AA&MR, Factset

HIGH-YIELD CORPORATE BOND SPREAD, BASIS POINTS

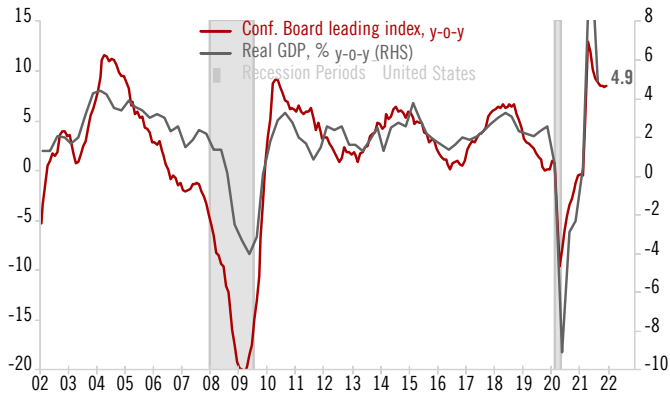


Source: Pictet WM – AA&MR, Factset (last close)

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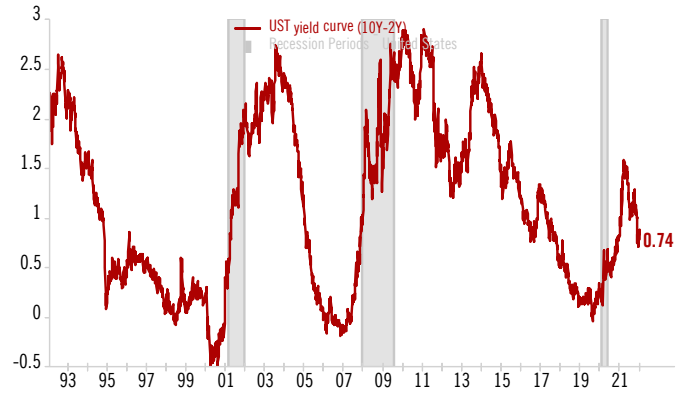
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CONF. BOARD LEADING INDEX, % Y-O-Y VS GDP GROWTH, % Y-O-Y



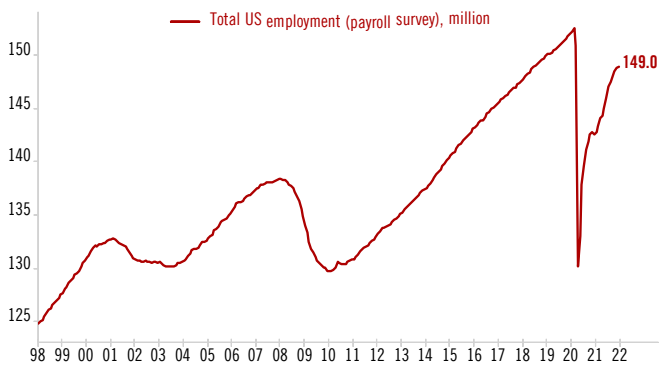
Source: PWM - AA&MR, Factset

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



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

TOTAL US EMPLOYMENT



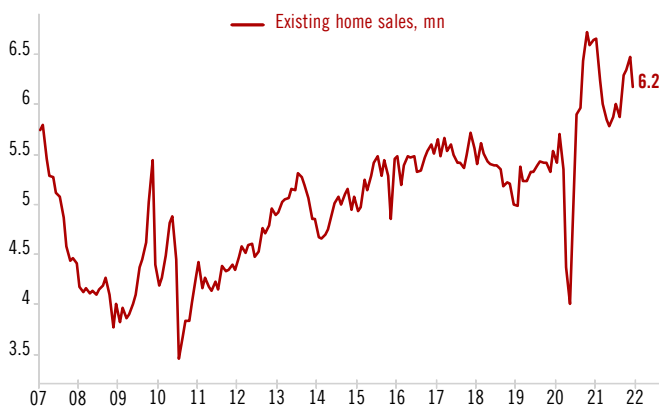
Source: PWM - AA&MR, Factset

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



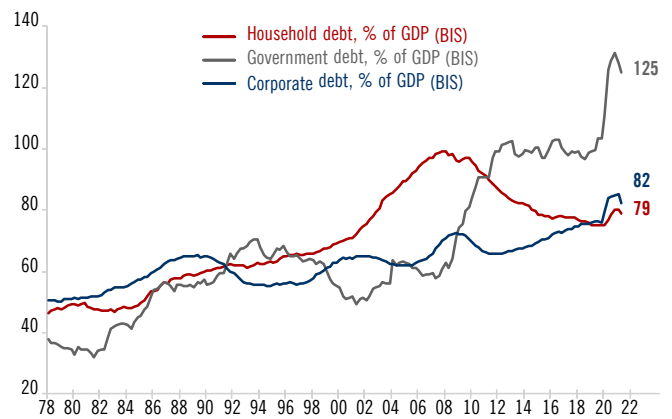
Source: PWM - AA&MR, Factset

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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