Weekly Market Summary

April 8th, 2022

Fed Willing To Walk The Walk As Inflation Hawks Ready To Fly
Abdulrahman Al Amer – Senior Sales Dealer

This week's Fed minutes showed the gloves are off!

It created momentary shudders of nervousness within the broad financial markets. The Federal Reserve has made it clear that a further rate hike of 0.50% is being considered, as the institution tries to combat inflation, which many analysts fear has escaped the grasp of the U.S central bank. Now, we shouldn't blame the Fed for everything. After all, they didn't cause all of the current inflation. That was mostly caused by trillions in government spending (the Treasury and fiscal policy) and the complex mess of supply chain issues during COVID. But the Fed could have done a lot more to get in front of this before it got out of hand and that's where their response is worthy of criticism.

It also seems like a solid bet the Fed did not want to scare investors in March with an aggressive larger hike, but now that the groundwork has been set, and a hike of 0.50% from the upcoming Fed meeting is on the cards the minutes showed. The minutes also laid down how the Fed will be shrinking the balance sheet. Officials broadly agree the Fed should shed up to $95bn of assets a month from the central bank's huge balance sheet and build up to that level over roughly three months starting in May. The Fed will seek to "roll off" $60bn of Treasuries each month by not reinvesting the proceeds from maturing bonds. When the amount of maturing Treasuries falls short of that level, the central bank has suggested making up the difference by reducing its holdings of shorter-dated Treasury bills, of which it holds roughly $325bn worth. The Fed also wants to reduce its holdings of agency mortgage-backed securities (MBS), which it started buying during the pandemic, capping the reduction in this asset class by $35bn a month. However, economists say it may fall short of this target given when the securities are expected to mature. U.S. equity markets slipped further into the red following the minutes' release, while the yield on the 10-year Treasury note jumped to a three-year high.

Although markets reacted negatively, Wednesday's FOMC minutes have been pre-empted. Federal Reserve Governor Lael Brainard's comments the day before reduced some of the potential for a surprise from the minutes. Brainard did not leave much to the imagination. The key line from Brainard's speech "the Committee will continue tightening monetary policy methodically through a series of interest rate increases and by starting to reduce the balance sheet at a rapid pace as soon as our May meeting." Brainard's words were loud given her dovish lean. In outlining her case, Brainard invoked Paul Volcker, the former Fed chief who tamed inflation in the late 1970s by aggressively tightening monetary policy and in turn causing a painful recession. He previously warned that runaway inflation "would be the greatest threat to the continuing growth of the economy . . . and ultimately, to employment".

And after Brainard on Tuesday, the FOMC minutes on Wednesday, the uber-hawkish comments continued. St Louis Fed President James Bullard - who as a reminder was the sole dissented in the latest FOMC meeting, demanding a 50bps hike instead of 25bps said on Thursday monetary policy benchmarks using "generous assumptions" suggest that the Fed may need to raise interest rates to about 3.5% to counter inflation that's running far too high. In other words another 300-325 bps of hikes. Bullard cited a version of the Taylor Rule to come up with his estimate for how high rates should go. Markets have already incorporated Fed tightening into their pricing, with the 2-year Treasury yield trading at around 2.45%, or 1 percentage point below what might be needed, Bullard said. It has also led to a yield curve inversion

suggesting the next recession is coming. A number of other Fed members spoke during the week. Fed President Mary Daly stated that the 40-year high inflation was equally as harmful to individuals as not having a job. Daly proclaimed that the Fed believes inflation will continue to rise for some time but tried to provide the people with some confidence. Increasing interest rates "is necessary to ensure that again, [you] go to bed at night, you're not worrying about whether prices will be higher, considerably higher tomorrow," the Fed president stated. Former Fed president Dudley stated to CNBC that the FOMC needs to "inflict more losses" in stocks (and bonds) in order to rein in soaring inflation: "If stocks don't fall, the Fed needs to force them."

That should spark volatility in markets as Jamie Dimon warned. JP Morgan's CEO told investors he did not envy the Fed for the steps the US central bank would need to take to end its ulta-loose policies but urged it not to "worry about volatile markets unless they affect the actual economy". The Fed will have to inject more uncertainty into rates markets if it wished to definitively tame inflation, boosting term premium and thus longer-term rates. A more volatile Fed means greater volatility of economic data, and greater volatility of asset prices too. The volatility of the Fed's target rate, which should rise this year, leads the realized volatility of U.S. equities. Implied volatility is unlikely to stay this low, if history is a guide. With stocks and bonds falling after Brainard's unexpectedly hawkish comments, the Fed reminded us it is the main engine of uncertainty, and the rise in the volatility of the Fed target rate and its balance sheet promise to ripple out across the economy and assets.

On the opposite spectrum, Russia's central bank cut rates by 300bps to 17% in a surprise move to stem the country's steep economic drop triggered by Western sanctions. It indicated more cuts are coming, in a sharp reversal from its emergency hikes in the wake of its war in Ukraine and in stark contrast with other major central banks which are rushing to tighten in the face of surging price growth. In a statement, policy makers noted that external conditions are "still challenging" but that capital controls have had their desired effect. The rate cut reflects a "change in the balance of risks" between accelerating inflation, declining economic activity and risks to financial stability. Notably, the central bank "holds open the prospect of further key rate reduction at its upcoming meetings. The stabilization of Russia's financial markets is illustrated by the swift recovery in the Ruble. The exchange rate has now rallied above its level on Feb. 23, the day before Vladimir Putin ordered the invasion of Ukraine. It had fallen by more than 45% year to date in the initial weeks of the invasion. But the stability looks fragile. Much of the Ruble's recovery probably reflects capital controls -- including asset freezes on non-resident investors and mandatory conversions of 80% of export earnings in foreign currency. Meanwhile, the economy is already shrinking, and analysts are expecting an annual contraction in GDP of almost 10% this year. The central bank is eager to avoid adding to the risks of a credit crunch with sky-high interest rates.

In oil markets, the marginal supply and demand pictures are both turning more negative for oil. This isn't necessarily about a major change in trend, but there's likely to be a deeper correction in the coming week or so, as the incrementally bearish news flow hits a market bulled up to the extreme. Brent crude futures fell below $100 a barrel for the first time since March 17 with the market assessing the impact of strategic crude releases as China grapples with fresh virus outbreaks. It has fallen below the key 50-day moving average for the first time since early January. From a fundamental perspective, the picture is one wherein an effort to tackle rising gas prices President Biden has authorized the release of an unprecedented 1m barrels per day for 180 days from the SPR (Strategic Petroleum Reserve). This increase in supply is in addition to the increase in production agreed by OPEC and its allies of 432k barrels per day although this is not due to begin until May despite calls or the increase to be brought forward. Plus, the IEA has also agreed to release 120 mln barrels of oil to ease prices, with the US providing half, the rest coming from other IEA members.

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