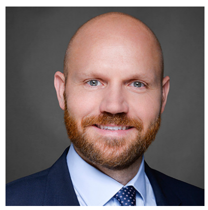
There Will Be Turbulence

Why this Fed hiking cycle looks different.

February 2022



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Well, it's certainly been an eventful start to 2022. To slay inflation—the ultimate villain—the major central banks have now shifted into full-blown tightening mode. Predictably, interest rates have reacted by selling off, and risk markets are on the back foot.

In the early stages of monetary tightening cycles, risk markets usually struggle at first before finding their feet. Below, I explore why this tightening cycle looks different and why I believe it will turn out to be an extraordinarily bumpy one for risk assets. Put simply: To bring inflation to its knees, central banks will need to keep risk markets off balance.

When Temporary Becomes Permanent

Only a few months ago, U.S. Federal Reserve Chair Jerome Powell described the inflation spike as "temporary" (in central bank lingo, the word temporary means a shock that does not require a monetary policy response). By the time of the January Federal Open Market Committee (FOMC) meeting, however, Powell had clearly changed his mind. With growth expected to run above potential and the labor market expected to tighten further, he made it clear that he believes the surge in inflation will exhibit some very "persistent" features.

Persistent inflation requires a policy response—in which case, Powell and his colleagues at the Fed have a real challenge on their hands. Monetary policy must be tightened to reduce the demand for labor—and we're not talking about a "benign" tightening to anchor inflation expectations or preemptively slow the economy before it hits full capacity. No, the economy is already operating at full capacity, wage inflation is real and persistent, and the central bank is behind the curve. Seen from this angle, the Fed finds itself in a situation that it has not been in for more than a decade.

In an ideal world, the Fed could tighten monetary policy and all risk markets would continue to trade well while the economy slows. But that isn't the world we live in. In reality, the Fed must accept either a strain on the markets or an economy that continues to grow above potential. At the January press conference, Powell made it clear that it would be the former.

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Financial conditions are not under direct control of the Fed, but the policy rate is a powerful lever and, if used persistently, it will move financial conditions in the direction the Fed desires. The exact nature of the tightening of financial conditions is the result of a complex interaction between growth and risk sentiment. When growth is strong, risk assets such as equities, credit, and foreign exchange tend to trade well. To drive financial conditions tighter against a backdrop of strong growth, the Fed must deliver a robust salvo of interest rate hikes. Although equity and credit markets are likely to remain resilient in such a scenario, the bond market would crack as the policy rate is driven to increasingly high levels, and eventually the dollar would strengthen.

Disruption Cannot Be Avoided

The tightening of financial conditions amid a backdrop of weak growth has a very different profile. When growth is weak, risk markets are frail. As the Fed embarks on the tightening process, financial markets switch to risk-off mode: Equity and credit markets sell off and the dollar appreciates. In this scenario, the longer end of the yield curve tends to remain resilient.

Regardless of the outlook for growth, if the Fed wants to slow the economy (for example, to reduce the demand for labor), it must pull the policy rate lever until financial conditions tighten. If my analysis is correct, the near-term outlook for risky assets is murky because any resilience they show will merely be met by another salvo of rate hikes. In short: The Fed is on a mission to keep risk sentiment weak.

Most monetary tightening cycles have not been like this. During normal cycles, the Fed preemptively tightens well before the economy is at full capacity. Typically, risk assets struggle initially but then settle—it is only toward the tail end of the cycle that we experience more serious market corrections. I think this cycle is different because the Fed believes it has fallen behind the curve because the labor market is already too tight and the economy is already growing too rapidly. This is why I expect this tightening cycle to be of the more disruptive, risk-off kind.

Don’t Be a Hero

For investors, this is no time to be a hero. Financial markets are likely to be choppy and trade with a risk-off bias. Eventually, this will offer opportunities for astute investors with the capacity to add risk assets to their portfolios during periods of market weakness. The sell-off in rates has been fast and furious, but if my expectation for the near-term growth trajectory transpires, the rate sell-off is already mature and we are likely to see some respite from the long end of the yield curve. I believe that Fed hawkishness will keep the front end of the yield curve anchored, and consequently, rallies in the long end of the curve will cause the yield curve to flatten. In line with historical experience, a risk-off environment should be a boon for additional dollar strength.

At this point, you might complain: “But if growth slows, surely central banks will just make a U-turn?” Maybe. But the key point in my analysis is that Powell believes that the Fed has fallen behind the curve, which will make a FOMC U-turn very difficult. Let’s not underestimate Powell’s resolve: In 2018, he hiked policy rates consistently even while unemployment rose. If the preeminent central banker of the world has decided that the labor market is tight and demand for labor must be cooled off, financial conditions will tighten.

There are no two ways about it, I’m afraid.

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