How fast can the Fed go?

In the wake of the Federal Reserve’s belated acknowledgement of the breadth and depth of the inflation pressures in the economy, markets are well on the way to pricing four interest rate rises this year. However, the Fed is also set to shrink its balance sheet, and how rapidly it moves here will have an important feedback for rate-hike calculations

Fed plays catch-up as inflation takes hold

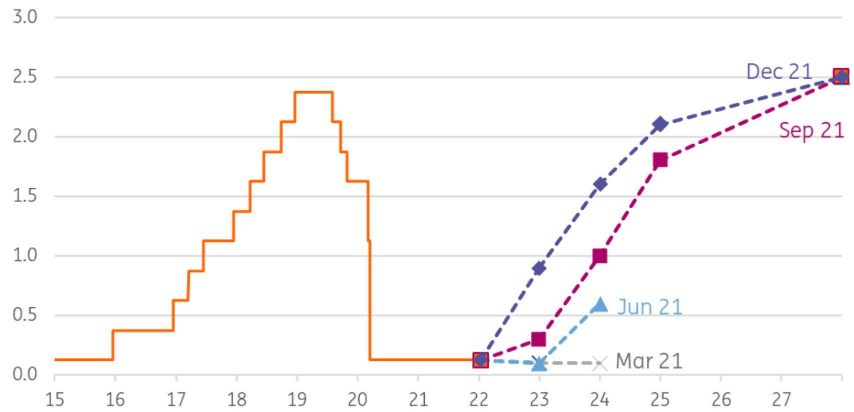
The December FOMC meeting saw yet another major change in the Federal Reserve’s thinking with the announcement of an early end to quantitative easing in March and the dot plot of individual member forecasts signalling three rate hikes in both 2022 and 2023.

This marks the latest in a series of shifts in Fed thinking:

- Last March, officials were still saying that a hike wouldn't come before 2024
- In June, they brought this forward to 2023
- In September, they had the first hike pencilled in for 2022 (but just one).

The inflation and labour market supply constraints that many analysts had been warning of caught the Fed off guard and they have had to catch up rapidly.

How the Fed's interest rate forecasts changed through 2021 - mid point for Fed funds target rate (%)



Source: Macrobond, ING, Federal Reserve

This can be neatly summed up in a couple of sentences from the minutes to that December FOMC meeting. “Supply chain bottlenecks and labor shortages continued to limit businesses' ability to meet strong demand. [FOMC members] judged that these challenges would likely last longer and be more widespread than previously thought… Most agreed that risks to inflation were weighted to the upside.”

On the labour market… “Many participants saw the U.S. economy making rapid progress toward the Committee's maximum-employment goal. Several participants viewed labor market conditions as already largely consistent with maximum employment”.

Market guns for March hike, but Omicron and employment costs are key

In the near-term, the Omicron wave sweeping across the US is only going to make matters worse. While it is prompting some consumer caution, it is also resulting in increased worker absences. This means more bottlenecks and supply chain strains that will hamper economic activity and keep price pressures intense through the first half of the year.

So, with both the inflation and the employment goals of the Fed pretty much met, we are very close to the point of rate hikes. The latest jobs report, which showed rising wage pressure and the unemployment rate breaking below 4%, plus the December CPI report showing headline inflation at 7%, have seen markets swing behind the view that the 16 March FOMC meeting will mark lift-off for interest rates.

Our official forecast, which we publish at the beginning of each month, currently has May as the starting point, based on the view that the Omicron wave would undermine the growth story in the near-term and the lack of visibility on the economic outlook would make the Fed hesitant to hike. However, the Omicron wave is already showing hints of peaking in New York where case numbers are slowing, as it has already done in parts of South Africa and the UK. This offers hope that US growth re-accelerates in 2Q as Omicron effects fade.

Moreover, the key data release we are now looking to is the fourth quarter Employment Cost

Index, the broadest measure of labour market inflation pressures, which will be published on 28 January. Should it come in close to the 1.4% quarter-on-quarter rate seen in the third quarter, thereby signalling labour market inflation pressures are becoming entrenched, it would be difficult to argue against a March rate hike and the prospect of four 25bp rate rises in 2022.

Balance sheet management can mitigate the need aggressive rate hikes

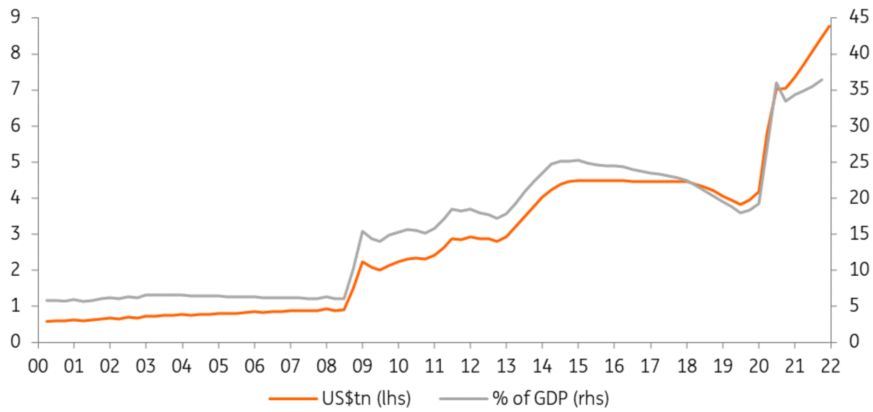
The Fed has stressed that changes in the Fed funds target rate remain the "primary means for adjusting the stance of monetary policy", but FOMC members "judged that the appropriate timing of balance sheet runoff would likely be closer to that of policy rate lift-off than in the Committee's previous experience".

This is important because the Fed can use its balance sheet to complement interest rate increases. By making the market absorb more government bonds (via the Fed shrinking its asset holdings) this can nudge up longer-dated Treasury yields. Given mortgage rates and corporate borrowing costs are more impacted by movements in 10-year yields than 3-month rates, the Fed funds target rate may not need to be increased as aggressively to get inflation under control.

In the last tightening cycle, the Fed raised interest rates in December 2015, while the announcement that the Fed would start to allow some of the maturing assets to drop off the balance sheet (by not reinvesting the proceeds) came 18 months later in June 2017 and was actioned in October 2017. This was conducted via introducing a cap on the amount of assets that would be allowed to run off the balance sheet. Initially it was just $6bn per month for Treasuries and $4bn for agency Mortgage-Backed Securities, beyond which everything else was reinvested. These roll off caps gradually rose to $30bn and $20bn.

As can be seen in the chart below, the Fed only managed to shrink the balance sheet by around $500bn before the pandemic struck and policy was dramatically loosened to stimulate the economy. Measured as a proportion of US GDP, the assets on the Fed's balance sheet dropped from the equivalent of 25% to 18% of GDP. Today, we are double that at 36%!

Assets on the Federal Reserve balance sheet in $tn and measured as a proportion of GDP



Source: Macrobond, ING

"Sooner" and "faster" than 2017

The desire to see a more rapid shrinking of the balance sheet has been noted in several recent speeches, including from the likes of James Bullard at the St Louis Fed, Esther George at the Kansas Fed, and Christopher Waller from the Fed's Board of Governors. Fed Chair Jerome Powell also acknowledged in his confirmation hearing this week that the balance sheet is "far above where it needs to be" and it is likely to start shrinking later this year. This statement also suggests we can't rule out the possibility that the Fed announces an immediate cessation of asset purchases at the January FOMC meeting.

We can quite easily imagine that the Fed leaves only six months between the first interest rate hike and the announcement and enaction of a reduction in the balance sheet. As in 2017, this will most likely come by phasing out the reinvestment of maturing assets, although the numbers will be larger than the initial $6bn Treasuries and $4bn agency MBS per month, given the balance sheet has doubled in size during the pandemic. We would suggest $10bn and $6bn per month initially being allowed to roll off before swiftly going up to $50bn and $40bn per month. Officials note that the current weighted average maturity of the Fed's holdings are shorter than five years ago so this structural change means the balance sheet can certainly shrink more quickly.

Balance sheet set to shrink by more than $3tn

In terms of how far they could go, Christopher Waller suggested in December that he would like to see the balance sheet brought down to around 20% of GDP from the current 36%. Assuming average nominal GDP growth of 5% over the next three years, this would imply a balance sheet of roughly $5.4tn, which would mean the Fed offloading $3.45tn of assets if it is serious about a swift "normalising" of policy. Even if it were to take seven years, we are still talking a shrinking of more than $2tn.

Some at the Fed may worry about the potential feedback onto risk appetite if they start going too aggressively, but with inflation set to remain extremely elevated through at least 2022 they seem to have little option. To hold back would only give more ammunition to critics who argue they are juicing equities. A longer drawn-out reduction would obviously require a less aggressive run down of assets on the balance sheet, but those are still going to be big numbers.

Let the yield curve do the heavy lifting

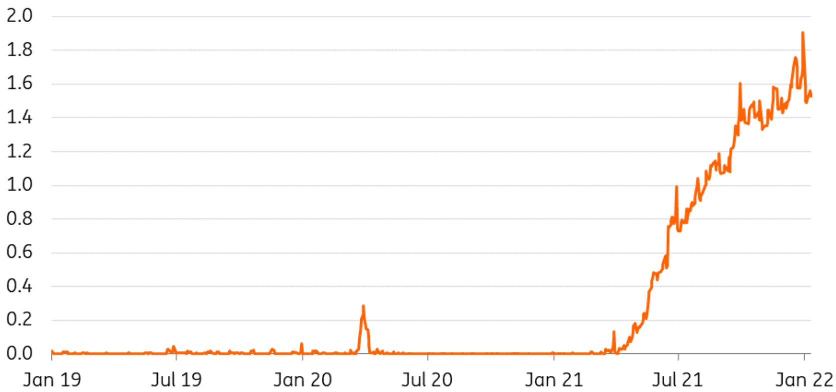
If this scenario pans out, it would contribute to a steeper Treasury curve than would otherwise be the case, with perhaps less need for aggressive rate hikes at the short end. After all, the Fed won't want to invert the yield curve – historically the best indicator of future recessions – and in any case, with mortgage rates and corporate borrowing costs priced off the long end of the curve this will have a more direct impact on borrowing costs throughout the economy. Moreover, "a few" FOMC members "raised concerns that a relatively flat yield curve could adversely affect interest margins for some financial intermediaries, which may raise financial stability risks."

Consequently, while we acknowledge the growing prospect of four rate rises this year, starting in March, our base case (and that of the FOMC members) of three rate rises in 2022 remains just as strong a call if the Fed's balance sheet is used to do more of the heavy lifting. Furthermore, an aggressive run down of the Fed's balance sheet suggests to us that the long run Fed funds rate may be closer to 2% rather than 2.5% as set out by the Fed.

Market dynamics and what to expect for liquidity and repo

As the Federal Reserve reduces its balance sheet, there will be a corresponding reduction in bank reserves. Effectively, the Fed will begin the process of writing down the amount of available reserves. As bank reserves ease, there is a corresponding reduction in liquidity swashing around the system. The last time the Fed went through a balance sheet reduction process, the market began to creak as liquidity dried up faster than the Fed had anticipated. There were some episodes of severe spikes in repo rates, reflecting a relative dearth of liquidity, especially at some quarter ends where banks are required to showcase ample access to liquidity.

About USD1.5tn of cash practically forced back to the Fed should ease lower



Source: US Federal Reserve

There are two nuances this time around. First, there is a mountain of excess liquidity in the system (chart above). At the moment there is some USD 1.5tn of cash going back to the Federal Reserve through the overnight reverse repo facility, for just 5bp (annualised). This is one measure of idle liquidity, a type that is out there looking for a home, even at rock bottom returns. Washing this out should be less fraught with tightness risks than we saw before. Second, the Fed has been perfecting a (new) standing repo facility in recent months. This allows eligible market participants to show up at the Fed with securities that they can lend overnight in exchange for liquidity. This is an important safety valve as the Fed takes liquidity from the system.

The net effect of tighter liquidity conditions should be upward pressure on market rates generally. There are two dimensions to this. First, the Fed will raise the funds rate directly. Second, as the ratio between liquidity and available collateral morphs to one that has less of a liquidity overload, there should be some upward pressure applied to market repo rates. This will not be instantaneous, as we'd need to get well into the balance sheet reduction process before we see an effect.

The other important dimension here is what the Fed chooses to do with the rate it charges on the reverse repo facility. This was at the floor of the fed funds range (zero to 25bp), but was hiked to 5bp in June 2021, partly to help avert a structural move into negative territory for general collateral repo, and in particular SOFR (our opinion). When the Fed hikes the funds rate by 25bp, in all probability the reverse repo rate will be hiked by 20bp to bring it back in line with the floor of the fund funds range. This will help take liquidity out of the Fed's reverse repo facility and into market repo. But this will take time. Should market repo struggle to trade above 25bp, interest in the Fed's facility would remain elevated, which would not be ideal.

Market dynamics and what to expect for rates right along the curve

The conversation on balance sheet run-off has become intense enough to argue that the Federal Reserve is more liable to surprise with a faster run-off than many had expected. Moreover, it is probable that the Fed employs this as a means of managing long-dated rates, even if they do not state this as an explicit objective. At the very least, this backdrop should help to place a floor on how low the 10yr rate can go, as in effect the Fed has (in theory) the capacity to put the 10yr wherever it wants. The Fed won't adopt such a dramatic stance, but the market should be aware that the Fed wants to get the funds rate up, and will not allow any (potential) collapse in the 10yr rate to frustrate that purpose.

There is no particular reason that the 10yr rate should collapse from a macro perspective, especially give where inflation is. At the same time, we know that strong demand for fixed income was a factor preventing market rates from rising as much as they could have in 2021. Apart from Fed buying, an important component of this was overseas demand. The likes of Japanese accounts among others were big buyers of Treasuries. The game where they had synthetically created alpha (when a wide rate differential created a currency arbitrage) disappeared when the Fed slashed rates to zero as Covid struck in early 2020. As the Fed hikes, that synthetic alpha creation game can re-commence, in turn reducing the need to buy Treasuries outright.

Hedge benefit between US and Japan for 1mth tenor should rise again as the Fed hikes

Source: Macrobond, ING estimates

Another pull factor for US market rates came from corporate setting fixed rate receivers, where they would receive "high" long-term market rates and pay ultra-low 3mth Libor rates. The difference between the two was a generous carry. Fast forward to today, and the equivalent carry opportunity is in fact higher, and some corporates will use this to set receivers. But the counter is that rises in the funds rate are significantly more likely now, and moreover the funds rate is primed to go higher, and quicker than many had anticipated. This means the carry is enjoyed for a shorter period, as Fed hikes cut into it. So, this remains a pull factor toward lower rates; but arguably likely to weaken as we get closer to actual hikes.

Generic demand for Treasuries remains in play in the coming months. This mutes the ability for market rates to rise with persistence. That said, as a theme going forward, there remain some persuasive reasons to expect upward pressure on market rates to dominate. Fed balance sheet reduction is a key one. Foreign demand is nuanced, as higher yields can tempt buying. Offset against that is a widening interest rate differential as the Fed hikes, allowing some players to get their alpha on top of low local rates through an evolving forward currency arbitrage. Add to that the pain from negative total returns from being long through the rate uplift journey, alongside a waning positive carry on fixed rate receivers.

Our target for the 10yr remains the 2% area for Treasuries, with a bias above. The USD Libor 10yr gets there first. For SOFR, that translates to the 1.75% area (c1.5% now), or above.

Authors

James Knightley
Chief International Economist, US
james.knightley@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com