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Fed vs. Omicron

Last week, the US Federal Reserve made a hawkish pivot in its policy stance. The latest dot-plot showed that majority of the Fed officials now expect to implement at least three rate hikes next year compared to the previous expectation of two rate hikes. Fed Chair Jerome Powell also announced that the Fed will double the pace of tapering of its bond-buying program. The Fed is contemplating an end to its aggressive monetary stimulus to address elevated inflation even as omicron is spreading fast in many countries.

Three rate hikes

Following the latest Federal Open Market Committee (FOMC) meeting, the Fed bared its updated dot-plot. It showed that 12 out of the 18 FOMC members now expect at least three rate hikes of 25bps next year. The Fed maintains that these projections are not cast in stone and that its decision-making will continue to be data-driven. However, this may put the Fed in a faster path of interest rate normalization compared to the consensus expectation of two rate hikes beginning mid-2022. Despite the change in its interest rate outlook, the Fed said that it will keep its benchmark rate near zero until the labor market reaches maximum employment. Fed officials expect this to be achieved sometime next year, with unemployment rate settling at 4.3% by end-2021 before declining to 3.5% by end-2022.

Double the taper

Aside from revising its interest rate outlook, the Fed announced that it will double the tapering of its bond-buying from $15b per month to $30b per month. With the faster pace of tapering, the Fed is scheduled to end its bond-buying program by mid-March, earlier than the previous projection of June. The end of the bond-buying program would not necessarily coincide with a policy rate hike, but it can open the door for a Fed lift-off that is much earlier than what investors expect. Powell explained that the Fed is phasing-out its bond-buying program at a quicker pace because “the economy no longer needs increasing amounts of support” in light of “elevated inflation pressures and a rapidly strengthening labor market.” The Fed chief further elaborated, “A quicker conclusion to our asset purchases will better position policy to address the full range of plausible economic outcomes.”

No longer transitory

US inflation climbed to 6.8% in November, the fastest pace since 1982, while core inflation reached 4.9%, its highest level since 1991. In its policy statement, the Fed observed that “Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation.” Powell explained that “bottlenecks and supply constraints are limiting how quickly production can respond to higher demand in the near term. These problems have been larger and longer lasting than anticipated, exacerbated by waves of the virus.” According to Powell, these caused overall inflation to run well-above the Fed’s 2% long-term target even as price increases have started to spread across a broader range of goods and services. In an earlier testimony to the US Senate, Powell said that “it’s probably a good time to retire that word (transitory) and try to explain more clearly what we mean” when talking about inflation. It is therefore apparent that the Fed has shifted gears and

is more prepared to tackle inflation that may potentially become more persistent than previously expected.

Market digests Fed move amid omicron threat

Last Wednesday, US stocks were down in early session, with the Dow declining by 155 points and the S&P 500 sliding by 0.49% at their intraday lows. Following the Fed announcement, the Dow closed 383 points higher while the S&P 500 was up 1.6%. It seemed like a sigh of relief for the stock market as the change in the Fed's outlook addresses risks posed by elevated inflation and provides a clearer path for interest rate hikes. However, the US market was down sharply over the next two days. Investors are still digesting the prospect of tighter monetary policy amid the new threat posed by the omicron variant. So far, we have seen some rotation out of high-growth tech stocks and into consumer names. As a result, the tech-heavy Nasdaq fell 3% last week while the Dow and S&P 500 were down 1.7% and 1.9%, respectively. Emerging market stocks also slid and EEM was down 3.9%, weighed down by weakness in the Chinese stock market. MSCI China ETF was down 5.8% for the week. Despite the poor performance of global equities, the PSEi was surprisingly resilient and posted a weekly gain of 1.5%.

Major policy dilemma

The dramatic shift in the Fed's policy outlook may be signaling the imminent end of ultra-aggressive monetary easing and the potential start of a rising interest rate regime globally. A faster tapering of the bond-buying program and three Fed rate hikes next year may put pressure on other central banks to also withdraw their monetary stimulus or tighten monetary policy. However, the omicron variant, which is more transmissible than past variants, continues to spread globally. Several major countries have imposed travel restrictions anew due to the threat of the new variant. If omicron is not contained, many more countries may have to close their borders and impose lockdowns, thereby hampering economic growth. Thus, the Fed and other central banks are now confronting a major policy dilemma. On the one hand, they want to reduce their monetary stimulus and eventually hike interest rates to address inflationary pressures. On the other hand, surging COVID-19 cases in many countries and the fast proliferation of omicron pose major downside risks to the global economy and may require a careful recalibration of the appropriate policy response.

We wish everyone a blessed and peaceful Christmas!

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