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Tough Fed talk on inflation, little bite

By Kerry Pechter *Wed, Mar 23, 2022*

'We prefer to take risk in equities over credit in the inflationary backdrop because we expect real—or inflation-adjusted—yields to stay historically low,' write BlackRock analysts.

The Fed last week signaled a large and rapid increase in its policy rate over the next two years and struck a surprisingly hawkish tone, indicating it's ready to go beyond normalizing to try to tame inflation.

It's easy to talk tough, and we believe the Fed is unlikely to fully deliver on its projected rate path. The reason? It would come at too high a cost to growth and employment. We do now see a higher risk of the Fed slamming the brakes on the economy as it may have talked itself into a corner.

The Federal Reserve has kicked off its hiking cycle with a quarter-point increase—the first since 2018. The decision was expected. What surprised was the Fed's stated goal to get the fed funds rate to 2.8% by the end of 2023 (see the pink dots on the chart).

This level is in the territory of destroying growth and employment, in our view. [Click **here** for the extended version of this commentary, with charts.]

At the same time, the Fed's latest economic projections pencil in persistently high inflation but low unemployment – even as it has called current labor conditions tight. We believe this means the Fed either doesn't realize its rate path's cost to employment or—more likely—that it shows its true intention: to live with inflation.

We think this is necessary to keep unemployment low because inflation is primarily driven by supply constraints and high commodities prices.

The Bank of England (BoE), the first major developed market (DM) bank to kick off the current hiking cycle, increased its policy rate for the third time to 0.75%. Like the Fed, the BoE recognized additional inflation pressures from high energy and commodity prices. It also signaled that it may pause further rate increases, with rates back at pre-pandemic levels. We believe this means the BoE is willing to live with energy-driven inflation, recognizing that it's very costly to bring it down.

The BoE provides a glimpse of what other DM central banks may do once they get back to pre-pandemic rate levels and the effect of rate rises on growth become apparent. The Fed's tone may change as the consequences for growth become more apparent after aggressively hiking this year.

The Fed last week perhaps wanted to appear tough by implying even more rate increases in future years to keep inflation expectations anchored, in our view, without expecting to deliver those hikes. To be sure: The Fed will normalize policy because the economy no longer needs pandemic-induced stimulus.

It has also signaled it will start reducing its balance sheet, marking the start of quantitative tightening. Finally, we expect the Fed to raise the fed funds rate to around 2% this year—close to pre-pandemic neutral levels—and then pause to evaluate the effects.

What are the risks? Central banks are in a tough spot. First, they may start to believe some of their own rhetoric—and think they can raise rates well above neutral levels without damaging growth. They could hike too much, too fast as a result—and plunge economies into recession. We think this risk has risen since last week's Fed meeting.

Second, inflation expectations could de-anchor and spiral upward as markets and consumers lose faith that central banks can keep a lid on prices. This could force them to act aggressively amid persistently high inflation.

Our bottom line

Last week's central bank actions reinforce our views. We see more pain ahead for long-term government bonds even with the yield jump since the start of the year. We expect investors will demand more compensation for the risk of holding government bonds amid higher inflation. We stick with our underweight to nominal government bonds on both tactical and strategic horizons.

We think the hawkish repricing in short-term rates is overdone and prefer short-maturity bonds over long-term ones. We prefer to take risk in equities over credit in the inflationary backdrop because we expect real—or inflation-adjusted—yields to stay historically low. We added to the DM equity overweight two weeks ago. We still like the overweight in this environment but see a differentiated regional impact from higher energy prices.

Market backdrop

Stocks rallied and government bond yields climbed last week after the Fed raised rates and Chinese policymakers soothed beaten-down Chinese markets. Chinese equities rebounded after officials suggested an end to the crackdown on tech companies and announced a relaxation of Covid restrictions to hit growth targets. We believe China’s ties to Russia have created a risk of geopolitical stigma, including potential sanctions.