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Rates Overview

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All of a sudden, rates and the Fed are interesting again. The market has priced in fed tapering, policy hikes and the potential for balance sheet reduction throughout the fourth quarter of 2021 and the start of this year, but for the most part that move has been fairly orderly. Consensus views moved in line with positioning, the market was expecting an orderly pace to fed hikes and the data supported that plan. The Fed was firmly in control of the message and prepared the markets for each and every tweak in policy, cutting down on unnecessary volatility or overly tight financial conditions. That all changed yesterday with the CPI print and James Bullard.

For those not as close to the markets, CPI surprised with a YoY headline print of 7.5% and an ex food and energy 6.0%, both above economists' expectations and both at persistently, shockingly high levels. A short time later, just ahead of the 30yr auction, St. Louis President Bullard hit the tape saying he was potentially in favor of a 50bps hike at the March meeting and 100bps in hikes ahead of July 1. The double shock left the market on the back foot and led to a nasty 20-25bps selloff in 2yr U.S. Government bonds and the market to quickly price in 75+% chance of a 50bps hike in March. Economists were quick to react with Bank of America calling for a 50bps hike and the potential for 1trn in balance sheet reduction in 2022 and Goldman Sachs moving to 7 hikes this year.

Taking a step back from yesterday's data and Fed speak, I would simply stress caution before getting too excited about more aggressive policy moves than are priced. I would still argue that the most likely scenario for March is a 25bps move and a signal to the markets that a hike at every meeting is on the table, but the fed will be monitoring closely. I also think balance sheet will be addressed in a balanced way with the fed starting by allowing bills to runoff before looking to potentially reduce MBS holdings later in the year, assuming all is going to plan.

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This scenario may not seem like "enough" to people looking at a 7.5% CPI or calling for aggressive policy moves sooner, but I can explain. To start, I would just go back to look at the basic goal of what the Fed is trying to accomplish: raise rates to remove emergency accommodation while still supporting an uneven economic recovery and avoiding a serious recession or asset price destruction. I do not think the Fed has the desire or the stomach to see significant asset price declines or market volatility and as such, will approach the coming months with caution and discipline.

Additionally, there are a lot of policy inputs currently beyond simply the fed funds rate. The Fed has employed a number of tools including but not limited to IOER, MBS purchases, repo, reverse repo and even corporate bond purchases at one point to effectively support the market. All of these tools are intertwined and matter on the exit. Further, at present, the market is not pricing in any longer term credibility issue or inflation problem at present. 30yr nominal yields remain below 2.5% and 10yr inflation break-evens are about the same. I find it curious that strategists feel that the Fed may need to hike 50, passively reduce sheet through bill run off and immediately start selling longer dated UST holdings when the market is telling you that the U.S. does not currently have a systemic and long term inflation problem.

This scenario also does not address a bit of the precarious position the Fed finds itself in for using all the tools outlined above. RRP has been an effective tool for the Fed to drain liquidity at a low cost, but what are the optics when the Fed starts paying 0.25%, 0.5% or 1.00% to drain those same reserves from the banks and money market funds? It's not hard to picture Powell sitting in front of Congress in an impromptu session focused around Federal Government payments to money center banks at a time when Main Street is suffering from inflation and/or tighter policy. Or how about when the Federal Reserve has to sell some of its UST holdings at a loss to achieve its goals? To be clear, I think all of this is hypothetical and I am being a bit over the top, but it gets to an important point. There are a ton of moving parts here that all have very different potential seen and unforeseen impacts on the markets and the economy. I think with that backdrop the Fed can afford to be more measured in what they are attempting to do.

In summary, I would argue that the Fed is trying to strike a very delicate balance of policy removal without unintended consequences. When I see a number like 7.5% CPI, I want to argue that 50bps should be on the table and it's time to be very aggressive. However, when I step back and think about the situation wholistically, I see no reason they would not move

25bps and start passive balance sheet runoff, then take a breath. The net difference of impact in policy of an additional 25bps tightening for the 6 weeks between meetings is not worth risking market confidence, asset price stability or the longer-term goal of what the Fed is trying to do.