Global Snapshot

14 January 2022

New Year Revolution

Wellian Wiranto
+65 6530 6818
WellianWiranto@ocbc.com

Why has the Fed turned this hawkish now?

- The market welcomed the new year in a less-than-celebratory mood, as the Fed jolted investors with increasingly concrete signals that it is poised to reverse its ultra-accommodative monetary policy stance.
- From an initial rate hike coming as soon as March and up to a total of four hikes for the year as a whole, the Fed has also stoked market anxiety further by telegraphing an outright reduction of balance sheet.
- Inflation is the overarching reason for the seemingly sudden turn, but a more nuanced dive into the underlying factors suggest that the Fed might just be turning hawkish right when the price pressure may have started to show signs of easing in the coming months.

The report is drafted in a Q&A format, featuring our composite hypothetical client, Mr. Q, whose incisive questioning style will not be unfamiliar to our long-time readers.

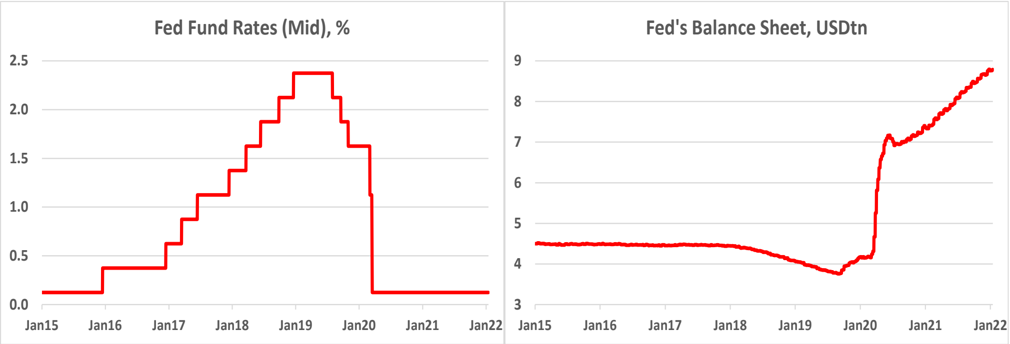
What a start to 2022! We are just in the second week of the year and so much drama already! First, why on earth is the Fed spooking the market so much?

Hi, Mr. Q. It has been a long while. You are right. It has been a rather eventful start of the year. Although if you look back, perhaps the last few years have been replete with a history of dramatic flair right from the get-go.

For one, in the opening weeks of 2020, a little virus which had not even been named yet was circulating surreptitiously in a city called Wuhan in China and likely beyond already. This time last year, there was of course the once-unfathomable siege at the US Capitol. More importantly from the market perspective, there were the surprise wins by the Democrats at the Georgia run-off elections which paved the way for the party to wrest control of the Senate and push through big stimulus packages.

This time round, although it is technically a blast from past in the form of minutes of the December FOMC meeting, the overall hawkishness of the tone once the details were released struck the market quite hard. In particular, the chatter about balance sheet reduction marks another milestone in monetary policy tightening by the Fed.

Not only is the market having to countenance a more rapid end to quantitative easing, to be followed then by rate hikes that could come earlier and with more salvos than previously expected, the Fed appeared to be actively contemplating an outright withdrawal of liquidity, as well.



Source: OCBC, Bloomberg.

That's quite a triple whammy, isn't it?

Indeed. It is true that this is not the first time that the Fed is going to undertake such a sequence of policy tightening. But, the previous time they pulled it off, it was over the course of four to five years. From the first taper in late 2013, to the first rate hike thereafter in 2015, and with quantitative tightening only starting to take place in 2017.

This time round, if we take the signals from the FOMC minutes at face value, there is a potential for all three tightening actions to take place within the year. Given that it is not so long ago that the Fed officials were busy downplaying the inflation risk – with the subtext that they would keep a loose monetary policy stance for a long time to come – it has been quite a sharp U-turn.

Why?

The short answer to your short question is really inflation. The Fed tried to dismiss it away as transitory but, as the actual underlying data suggest, it had been anything but transitory. To begin with, headline CPI inflation has been inching up and has reached 7.0% yoy for the month of December, the highest since 1982. Indeed, technically speaking, the Fed's inflation target of 2% has been breached since March 2021, with widening gap at that.

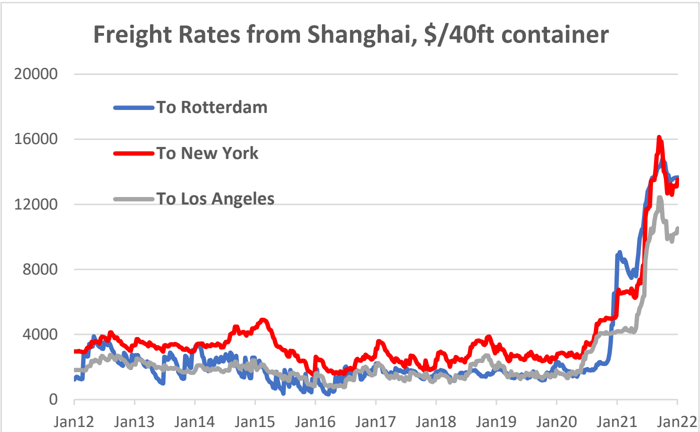
Even if the Fed has formally adopted an average inflation target which allows it some wiggle room on the upside, the seemingly relentless uptick which widened the gap between actual and targeted inflation numbers has proven to be too hard to wave away.

There might be a political element to it, as well, with the Biden administration facing a sliding approval rating ahead of a crucial midterm election this year that might see the Democrat party losing control of both chambers of the Congress. Given that their traditional working-class voter base is hurt more by rising prices, the administration has become increasingly vocal about the need for the Fed to counter price pressure.

With some polls such as a recent one by ABC/Ipsos signalling that more than two-thirds of Americans disapprove of how Biden is handling inflation, the compulsion to nudge the Fed to be more hawkish is understandable, notwithstanding the notion that it is an independent institution.

Okay. Then the question becomes, why has inflation been so high? Is it because of all these supply chain backlog that we keep hearing about?

That does play a role. As we noted before, the tortured supply chain backlog has manifested in various ways across the globe. Some shortages may seem relatively trivial, such as how McDonald's ran out of French fries in Japan and of hash browns in Taiwan. Others are less so. The ongoing semiconductor chip shortage continues to impact the availability of cars, for instance, with as many as 11.3mn units of production lost in 2021 due to chip shortage, some reckoned.



Source: OCBC, Bloomberg.

Meanwhile, shortages of containers and port workers have resulted in shipping backlog, which inadvertently pushed up distribution costs too. While the indicative freight costs from Shanghai to major ports in the US and Europe have declined somewhat in recent months, they remained at multiples of pre-Covid era. This is but one layer of extra costs to producers which are already experiencing price upticks, making it more likely for them to pass on the extra costs to consumers like you and me.

The overall reality is that the lack of supply has pushed up the prices paid for whatever items that are still available.

I get it that if goods are not readily available, prices would go up. But, how much of the inflation uptick has been driven by an increase in demand too?

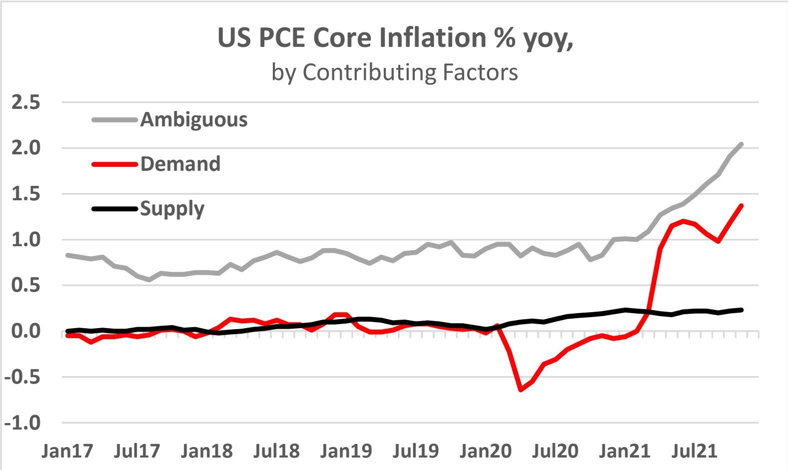
That is an intriguing question, but the underlying dynamics is probably Economics 101. Even if something is not available, prices would not go up automatically if there is no demand to begin with. Indeed, that was probably what we saw at the start of the pandemic when uncertainties were so heightened. But, as it became clearer that the world was not going to end, demand did come back – and strongly at that.

In the US, that was in part driven by a series of direct stimulus cheques. Starting from March 2020, eligible Americans started to receive $1,200 each. Most recently in March 2021, the Biden administration rolled out direct cash payments of up to $1,400 for individuals earning less than $75,000 a year, plus the same amount per dependent.

While some studies suggest that the main bulk of the stimulus cheques were either saved or used to pay down debt, with approximately just 40% spent on goods and services, the stimulus nonetheless provided a crucial cushion that allowed consumer demand to bounce back quickly.

So, supply is down at a time when demand is up. Hence price goes up.

Voila. Of course, the next puzzle may be which factor might have dominated. According to estimates by the San Francisco Fed, it appears that even though supply factors play a role, the demand component has dominated of late.



Source: OCBC, San Francisco Federal Reserve.

Is that why the Fed has turned aggressive on inflation suddenly?

Well, it is probably one of many internal studies that added to its tightening impetus. There is obviously more logic to withdrawing monetary policy accommodation to curb inflation, if the underlying inflation has been due mainly to demand uptick than supply shortfall.

After all, it is not like, just because the fed funds rate gets higher, the container ships will sail faster, and the semiconductor foundries can churn out more chips per hour. But it would have some effect in curbing demand by raising the propensity to save rather than consume at the margin.

Still, I would caution against reading too much on this one study alone. For one, the authors note that, even though demand-led factors supersede supply-driven ones, the bulk of the estimates remains in the ambiguous territory where it is not clear which factor is the dominant one.

The fact of the matter is that it is not a clear-cut story. After all, I can imagine scenarios whereby low supply begets high demand on its own, with consumers scrambling to get hold of something, anything ranging from the new PlayStation5 or the new shiny sedan just out of fear of not being able to get hold of one – which would then make that fear self-fulfilling in the end.

That's the FOMO effect then!

Yes, and I'm glad to see how conversant you are with millennial-speak, Mr. Q.

Well, I picked that up from your ABC report on Cryptocurrencies, actually.

Nice, thanks for reading. In any case, the fear of missing out part might well help to explain the about-face of the Fed recently as well. With the headline prints going up and up, it just became harder for them to swat it off as being merely transitory. Moreover, there has been a growing chorus of concerns about how the Fed has missed the boat when it comes to tightening and would be behind the curve of inflation even more if nothing is done.

Are they behind the curve now though?

Purely in terms of what they have *done*, perhaps. All that they have *done* is tapering, which is to add less and less liquidity in the market. However, of course, it has signalled a lot more than that, with the potential for rate hike to come as soon as March and an outright reduction of balance sheet thereafter, as we mentioned earlier.

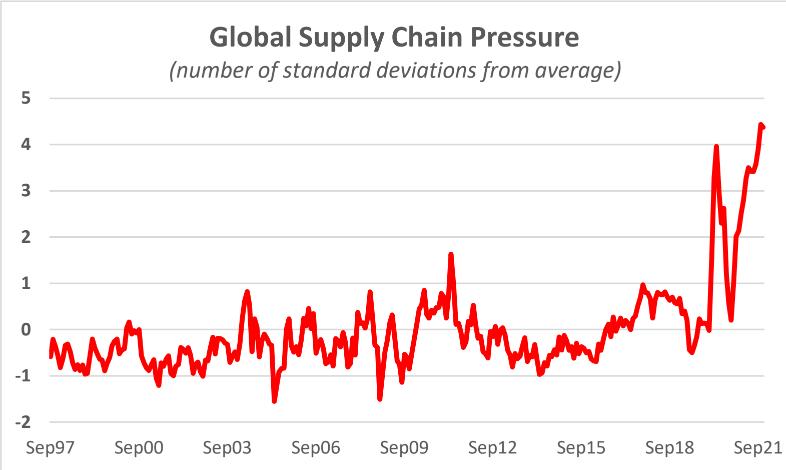
I do wonder still, however, of the scenario that when they actually start pursuing all these tightening actions, inflationary pressure might have begun to ebb as well. Hence, in that case, it is not so much that they are behind the inflation curve, but the curve itself might start to turn.

Wait a minute. Are you saying that inflation might not be an issue anymore?

That is one possibility. For one, the market has started to tamp down expectations of US GDP growth for 2022, in part because of the omicron-driven Covid-19 wave that is hitting the country quite hard now. The fact that Biden's plan for new fiscal stimulus package appears to be dead now is another factor.

Hence, the consensus expectation now is for the US to grow by 3.9% this year, compared to 4.3% just four months ago. If we then take the view that demand is the bigger driver of price pressure, that could also mean that a relatively softer demand outturn might be coming, which would in turn dampen the inflation risk, as well.

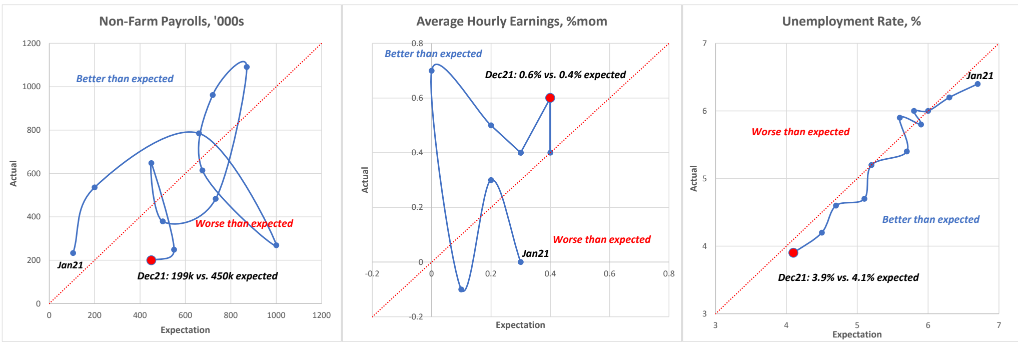
On the flip side, as much as it is hard to imagine now, supply factors might be less menacing too. Going by estimates from the New York Fed, the bad news is that, yes, the global supply chain pressure remains at a high level – at over four standard deviations above its long-run average. The not-so-bad news, however, is that it has also started to ease, even if at a very gingerly pace. That is in line with a better outturn in the supplier delivery sub-index of the ISM manufacturing report in December, for instance, suggesting a net relative easing in the supply chain issue.



Source: OCBC, New York Federal Reserve.

Okay. Those sound like good news to me. But, despite such relatively positive signals, what would still concern you about inflation uptick in the coming months?

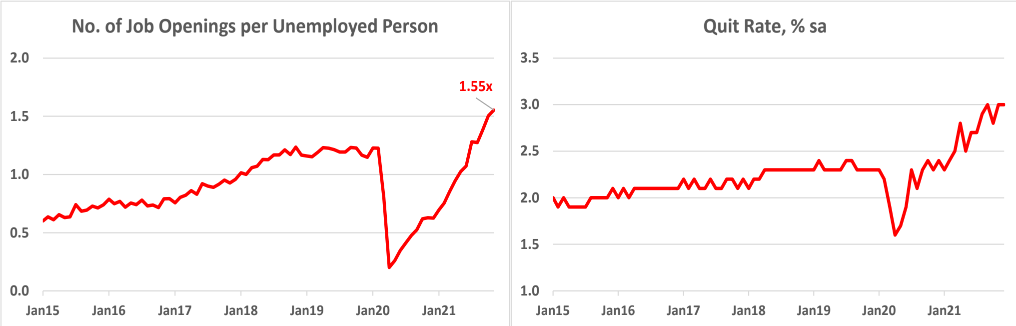
The area I will watch most closely is the tightness of the US labour market. The latest employment report is literally all over the place, with the nonfarm payrolls surprising on the low side for the second month running, but unemployment rate dipping down to 3.9%, the lowest since the pandemic began. One thing that struck out to me is the continued strength in wage growth, however, since that could feed directly into the inflation concerns.



Source: OCBC, Bloomberg.

There is also the sense that the labour market may stay tight for a while, partly because of the onset of the Omicron strain. Because of its higher transmissibility, it has been spreading so rapidly that more and more workers are forced to stay at home. The fact that schools have to be shuttered due to teacher shortage and fear of virus spread have also added to delays in people returning to the workforce, because of childcare duties.

Indeed, as a measure of just how tight the labour market has become – leading to a potential for further wage hikes to attract workers – there is now a record high 1.55 times job opening for every unemployed American to choose from. Another way to visualize this is that, even if we manage to somehow match all the Americans who currently do not have a job with the existing openings – ignoring qualification and geographical requirements, etc – there will still be as many as 3.8mn positions that remain unfilled. The rate at which workers quit their jobs has also been climbing, with talks about how we are in an era of the "Great Resignation" to boot.



Source: OCBC, Bloomberg.

So the risk is that, even as supply chain disruptions may ease together with end-demand, the tight labour market – which would force companies to pay up or lose out – may keep inflation prints at a relatively high level for some time still.

Putting all these together, the Fed is right to strike such a hawkish tone then?

In some ways, with the benefit of hindsight, the Fed could have struck such a tone a tad sooner, which would limit the shock factor to the market. From here on, however, from the market pricing action, it does look like the first hike could crystallize as soon as the March meeting, with about 90% probability. For the year as a whole, as many as 3.6 hikes are now priced in, which suggest that 4 hikes are par for the course already.

To be sure, that would be a sharp departure from the low-rates-for-longer-if-not-forever mode that the global markets have lulled itself into and can present a tricky period of adjustment. However, real rates – the level of rates after adjusting for inflation – would remain at negative territory for a while, which should still support risk sentiment.

Moreover, as of now, even as the Fed appears to be itching to hike rates, ultimately, they would still keep rates at a relatively low level. Going by the dot plots from the December FOMC meeting, the median expectation for policy rates in 2024 is at 2.1%, still below what we saw in 2019 when the Fed funds rate was capped at 2.5%.

So, long story short, yes, the Fed looks ready to hike rate because inflation has run longer and higher than they had expected. Market is likely to be

choppy as investors recalibrate to the departure from low rates environment, but ultimately, things should not be too bad because rates should still be at a relatively low level.

Yes, indeed. I could not have summarized it better myself, Mr. Q. Thanks.

Okay. I do want to talk to you more about the impact of such a global backdrop on emerging markets overall, and especially Indonesia and Malaysia that you look at closely. But that's for another time.

No problem. It will not be a smooth ride for these economies because of the new global reality, but let's talk more again next time. Thanks.

Treasury Research & Strategy

Macro Research

Selena Ling
Head of Research & Strategy
LingSSSelena@ocbc.com

Tommy Xie Dongming
Head of Greater China Research
XieD@ocbc.com

Wellian Wiranto
Malaysia & Indonesia
WellianWiranto@ocbc.com

Howie Lee
Thailand & Commodities
HowieLee@ocbc.com

Herbert Wong
Hong Kong & Macau
herberthtwong@ocbcwh.com

FX/Rates Strategy

Frances Cheung
Rates Strategist
FrancesCheung@ocbc.com

Terence Wu
FX Strategist
TerenceWu@ocbc.com

Credit Research

Andrew Wong
Credit Research Analyst
WongVKAM@ocbc.com

Ezien Hoo
Credit Research Analyst
EzienHoo@ocbc.com

Wong Hong Wei
Credit Research Analyst
WongHongWei@ocbc.com

Toh Su N
Analyst
Tohsn@ocbc.com