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BREAKING NEWS
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A quicker end to QE as the Fed considers its next move

Amid a reacceleration of growth and inflation, the Fed announced it will speed up the pace of winding down quantitative easing, setting a path to end the program for good in March. Milder inflation in 2022 should allow the Fed to wait longer than the market expects before raising interest rates.

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WHAT HAPPENED?

The Federal Reserve Open Market Committee (FOMC), feeling heat from inflation and pressure from a tightening labor market, announced it will end its asset purchase program, commonly known as quantitative easing (QE), earlier than first announced. The Fed will reduce its purchases by $30 billion per month rather than the original $15 billion, setting a path to end the program in March.

But that wasn't the only news the Fed made at this meeting. The median expectation on the so-called "dot plot" of interest rate forecasts now calls for three rate hikes in 2022, up from less than one in the previous forecasts released back in September.

Changes to the economic forecasts tell us why. The committee expects real GDP growth to be higher next year and the unemployment rate to fall by more, helping to create a hotter inflationary environment. The median forecast for core PCE inflation, which the Fed attempts to keep close to 2%, is now 2.7% for 2022.

The Fed's accompanying statement preserved its long-standing pledge to keep the target rate at zero until the labor market reaches maximum employment. It is clear now that a large majority of members believe that test will be met within the next six months.

Markets were already pricing in close to three rate hikes for 2022, so even the relatively large upward revision did not create too much turmoil in the immediate aftermath of the meeting. The overall economic environment the Fed expects next year – 6.6% nominal GDP growth, falling unemployment and significant disinflation with the policy rate still below 1% – is very positive.

WHAT'S CHANGED SINCE NOVEMBER?

It's unusual for the Fed to change its tune as quickly as it has since September. Over that time, however, growth and inflation data have significantly exceeded expectations. While the Fed does not target headline Consumer Price Index (CPI) inflation, it has undoubtedly taken note of the 6.8% increase over the past year, the highest since 1982.

In a mirror image of unexpectedly rapid price increases in 2021, unemployment has dropped surprisingly fast. One year ago, the Fed projected the U.S. unemployment rate would be at 5.0% at the end of 2021 and down to its current rate of 4.2% only by the end of 2022. In other words, the labor market is a year ahead of schedule, at least by this measure.

On the other hand, the new threat posed by the Omicron variant of COVID-19, while still largely unknown, will likely lead the Fed to exercise patience when considering an outright tightening of monetary policy. But the FOMC will also likely be encouraged by the overall diminished policy risk environment since its last meeting, with the U.S. Treasury's debt ceiling on its way up without incident and Congress – so far – avoiding a federal government shutdown.

Markets have also weighed in on what's been happening with the economy and the Fed's role in it. Real interest rates – a measure of how loose or tight financial conditions are – recently hit new all-time lows, while inflation expectations remain elevated. While close to three rate hikes are priced in for 2022, the level of nominal interest rates remains historically low, a sign that bondholders do not yet see a reason to run for the exits.

Most of the developments over the past six weeks point to stronger growth and hotter inflation, which recommends a flexible approach for monetary policy next year. By ending its taper by the end of Q1, the Fed will have time to assess its impact and remain patient, while preserving the ability to raise rates – if necessary – as soon as June without causing undue alarm in markets.

SLOWER. BUT STILL PRETTY FAST FOR 2022

Looking ahead to 2022, we think investors – and, after today, even the Fed itself – are anticipating too much tightening. Inflation is likely to decelerate substantially as supply chain fixes lower goods prices and more workers enter or reenter the labor force. Central banks have helped engineer one of the fastest and strongest economic recoveries on record, and they aren't keen to squander it by raising policy rates too soon or too fast.

The Fed, in particular, has adopted as part of its unofficial mandate a desire to foster economic growth that is broader (i.e., more equitable) than the long and slow comeback from the global financial crisis in the 2010s. We see the U.S. unemployment rate falling below its pre-pandemic low of 3.5% next year, but the employment-to-population ratio remains on a long-term downtrend as more workers age into retirement. This may give the Fed reason to wait longer before applying the brakes to this economy, as it wishes to attract as many potential workers as possible into one of the over 11 million open jobs. "What is maximum employment?" will be the key question for monetary policy in 2022.

We remain bullish on risk assets, particularly those with closer ties to the economic cycle. This includes cyclical parts of the global equity market, specifically U.S. small cap stocks, financials and the eurozone. Income generation remains a challenge given the level of rates, but we are focused on opportunities at the nexus of lower credit ratings, strong fundamentals and helpful technicals. Preferred stocks, bank loans and high yield municipal bonds are among our favored options for bond investors in the new year.

For more information, please visit us at nuveen.com.

Endnotes

Sources

Federal Reserve Statement, December 2021.

Bloomberg, L.P.

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