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BREAKING NEWS
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Inflation won't go away (quickly), forcing the Fed to act

To the nameless economists who played down the risk of inflation, 2021 was a year to forget. This week's data confirmed that U.S. consumer prices rose 7% last year while core prices rose by a slightly-less-eye-popping 5.5%. The Fed is shifting its tone.

Brian Nick
Chief Investment Strategist

THE STATE OF INFLATION

The patterns in last month's CPI report were familiar: Durable goods (+1.2%) were outsized drivers of price increases. Within that category, used cars were the biggest outlier, rising 3.5%. Overall, services inflation remained relatively tame at 0.3%, but shelter inflation – which is notoriously difficult to account for given how many people own their own homes – has been running hotter than normal.

Inflation in 2021 owed much to the positive demand shock from multiple fiscal stimulus measures in the first half of the year and the ongoing shortage of semiconductor chips that go into products like cars. The highest months for inflation occurred in the second quarter of last year, but Q4 marked a return to inarguably elevated inflation that is capturing more than just hiccups in global supply chains.

THE FED MAKES AN ABOUT-FACE

Until last year, it would not have come as a surprise to markets that a central bank whose economy had just experienced a year of 7% inflation might look to raise rates (OK, other than the Central Bank of Turkey). But Fed's shift in tone has been abrupt, from the "all is well because inflation is transitory" talk of September 2021 to the "actually inflation is a severe risk" message Jay Powell delivered in his confirmation hearing just this week. What's driving the Fed's change of heart?

1. Supply chain issues aren't going away fast enough, and durable goods prices continue to rise when the Fed and others likely expected them to be correcting by now.
2. The unemployment rate has dropped really far, really fast and the recovery in labor force participation has been disappointing.

The Fed is worried about a high inflation mentality settling into the economy. Goods prices are still high and rising, while sharply increasing wages in some areas are pressuring profit margins and, potentially, prices. We may be seeing a bit of that in the inflation numbers. Price increases at restaurants and personal care stores – jobs that tend to be labor intensive and offer relatively low wages – accelerated in Q4 despite the expiration of enhanced unemployment benefits in September.

WHAT COMES NEXT?

Our view coming into 2022 was that the Fed could and would wait longer to see where inflation settles before raising rates. But it now appears to be taking inflation risks much more seriously, with a rate hike now very much in play as soon as March. Markets have gotten the message, as well, with fed funds futures contracts pricing in between three and four hikes from the Fed this year.

The Fed also appears primed to embark on quantitative tightening (QT) as soon as the second half of this year. QT occurs as the Fed allows maturing securities to roll off its balance sheet without replacing them, draining liquidity from the financial system and tightening overall conditions.

The magnitude of this potential tightening remains unclear, because the Fed has not said how fast it will allow securities to roll off or what the terminal size of its balance sheet should be. We know from the minutes of the December FOMC meeting that the process will happen "sooner" and "faster" than it did in the last cycle, but the total amount of balance sheet runoff will likely only amount to the equivalent of about one rate increase a year for as long as the Fed chooses to do it.

OUR BROADER MARKET OUTLOOK IS MATERIALLY UNCHANGED

This change in the Fed's communication – which drives the change in our view on rate hikes this year from zero to three – does not materially change our outlook for broader markets this year. We still do not see a scenario in which the Fed's actions dramatically tighten financial conditions. This makes the debate between one hike and three hikes (or even four) far from life or death for the economy.

It *will* matter, however, where and when the Fed stops hiking in 2023 or 2024. In the last few weeks, the Fed and the market are increasingly aligned on those years, with the Fed expecting to remain below its 2.5% equilibrium estimate at the end of 2024. Anything short of that rate would, in the Fed's eyes, still been considered accommodative policy.

It is not just the fed funds market that's taken notice of the Fed's changing posture. Equity markets have begun 2022 with an abrupt change in leadership from defensive and higher growth stocks to cyclical and value names. Energy stocks are off to a roaring start while financials are benefiting from higher rates and a slightly steeper yield curve.

Credit markets are performing well despite the rate volatility. We know from experience even before the pandemic that periods of sharply rising rates are typically followed by better returns on equity and credit markets. We expect the lurch higher at the outset of 2022 to prove no exception.

Our view coming into 2022 was that strong economic growth and benign disinflation would propel real interest rates higher and help recent underperforming segments of the market to outperform – including the eurozone and U.S. value stocks. It's safe to say we did not expect the trade to work quite this quickly. But we still see scope for it to continue based on our view that the U.S. Treasury curve can steepen further, with the 10-year yield ending near 2.5% for the year.

The Omicron variant remains a wild card for economic growth. Countries that attempt to contain the virus via strict mitigation measures could suffer economically in the first quarter as Covid waves ripple through the globe. We do not expect this wave to be as inflationary in the U.S. since the prior two were due to lack of fiscal stimulus to U.S. households. But disruptions to global manufacturers and supply chains could leave goods prices higher for longer.

Omicron and concerns about policy tightening add to our conviction that 2022 will be "Slower" than 2021 "…but still pretty fast," and overall that should benefit investors with diversified portfolios and risk-on positioning.

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

Endnotes

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