The Federal Reserve Open Market Committee made no changes in interest rates today, as expected, staying with the target of 0.00-0.25%. But, times are changing.

The formal statement language was significantly simplified from December, that economic activity and employment have 'continued to strengthen', but also acknowledged the sharp recent rise in Covid cases on particular sectors. High inflation was attributed to ongoing 'supply and demand imbalances'. However, the FOMC expects that it will 'soon be appropriate' to raise interest rates. The tapering off of treasury and mortgage-backed bond purchases was ramped up, scheduled to end in 'early March'.

The first adjustment in Fed policy over the past month has been the expectation (ratified by the Fed today, but also signaled beforehand) of a quickening in the pace of the tapering off of treasury and mortgage-backed bond purchases. This represents a slowing down of the stimulus policies begun in 2020. Persistent inflation, being no longer 'transitory' (per Jerome Powell's words), has been the most important recent challenge, with growing pressure to stop helping an economy and monetary base that no longer needs to be helped.

Secondly, the conversation has rapidly moved to interest rate increases—but by when and how much? Earlier estimates pointed to late 2022, but these have inched closer to potentially as soon as the March meeting. This timeline isn't a guess, but comes from comments by Fed officials in speeches/interviews (as they like to spill the beans in advance to prime expectations and prevent surprises). It is assumed rates will rise in normal 0.25% increments, but there's been some speculation about one or several 'shock and awe' 0.50% hikes. While possible, that type of larger hike isn't seen as likely, with the Fed acting so cautiously as of late. Current consensus is four rate hikes in 2022, totaling 1.00%, which would equate to one at every other meeting.

Thirdly, the Fed's $9 tril. balance sheet may also be reduced at a faster pace than in the past, if hints from Fed members are any indication. The 'balance sheet' represents the bucket that holds all treasury and MBS bond purchases, now being tapered off. The definition of balance sheet reduction implies that currently-owned securities will be allowed to mature, with proceeds not reinvested, which would allow the sheet size to decline naturally. However, there is some growing pressure to eventually sell bonds outright to speed the process, which the Fed has not been as keen on due to potential market disruptions (particularly at the longer-end of the yield curve, where this has more of an impact than fed funds rates). At the very least, it seems the Fed would like this run-down done at a quicker pace than after the Great Recession. This is again speculation, but based on anecdotal comments, a reduction could start after a few rate hikes have occurred, but could start sooner. A balance sheet of this immense size, though, will take a lot of time to fully unwind, as even a 'fast' run-down pace would only trim a few trillion worth over the next several years. Quantitative easing, the bond-buying responsible for the expanding balance sheet, has been a tool used to keep longer-term interest rates manageable (low), and a change in purchase/sale expectations could be disruptive to markets. This third leg requires more deliberate care, for that reason alone. Overall, the Fed doesn't want a balance sheet this large, as it acts as a drag to normal market functioning, and provides less of buffer should the Fed need to provide stimulus again in the next recession.

The Fed's evaluation metrics have been moving in the direction of strength, with easy policy increasingly less appropriate:

<u>Economy</u>: Expectations for U.S. GDP growth for the first two quarters of 2022 have vacillated due to the Covid omicron variant's impacts, but the full year 2022 expected growth number remains around 3-4%. The last two Covid variants have successively delayed growth, with some 'catch up' still expected in upcoming quarters. This looks to be the end of the pandemic recovery spurt, though, with estimates for 2023-24 and beyond falling back into the pre-Covid 2.0-2.5% trend range.

Inflation: The December year-over-year CPI numbers came out at 7.0% and 5.5% for headline and core, respectively. These are the highest readings since the early 1980's, with economists continuing to debate the causes and expected longevity of the spike. These are: (1) supply/transportation disruptions and closures from the pandemic, coupled with high demand for consumer goods (that is currently hard to fulfill); and (2) excessive fiscal stimulus spending flowing through to the money supply (M2 cash balances, etc.). While likely a mix of both, the timeframe for solving inflation has lengthened—although a slowing from peak levels is expected for later 2022 and into 2023. Despite the causes and move to normalization, these high levels have pushed the Fed into faster action, with ongoing bond-buying and zero interest rates looking inappropriate under such conditions. Inflation rates in a few years are estimated to remain higher than expected, such as 2.5% versus the Fed target of 2.0%, for example, which the Fed actually wanted to make up for inflation shortfalls prior to the pandemic.

Employment: After showing mixed recovery results at times during 2021, most measures are showing an increasingly robust jobs market. In fact, it appears the balance of power has shifted from employers to employees in many cases, shown by still-few available workers, rising wages, and historically high quit rates. The headline unemployment rate has also fallen quickly in recent months, arguably into the gray area of 'full employment', making low rates based on this measure also less appropriate. There is an economic mystery surrounding the 'missing' workers, which became unemployed during Covid and just didn't return—it assumed this is a mix of those living off of savings, some concerned about virus transmission, those with elder- and child-care responsibilities, and early retirees. The greatest disruption is in lower-wage and also specialty workers, which can't participate in remote work. A longer-term fear that economists mention is the 'wage-price spiral', a longer-term situation where higher worker wages lead to higher inflation for everything, although that seems premature.

Looking at these measures as a whole has made the idea of a rate hike the obvious next move. However, raising rates sharply to combat inflation, for one, is trickier than it appears. Monetary policy changes operate with a lag (of a few quarters or so), and rapid responses can have undesired effects of stomping on the 'brakes' too suddenly, which risks a too-fast slowdown. Then again, not braking enough runs the risk of the car hitting potential speed bumps at too fast a speed. Another risk of too much tightening is that inflation begins to fall naturally as it's happening. This reduces one threat but enhances another—the risk of recession—or even a reversal into deflation (that being one of the biggest long-term concerns of the Fed). Financial markets have reflected the uncertainty so far this year, with downside volatility based on fears of the Fed raising rates more than expected and/or making a policy error. The 'certainty' of today's FOMC statement in keeping with expectations may have been a partial catalyst for today's equity market recovery.

Finding a way to achieve 'soft landings' is the eternal goal of central banks. That special place has been difficult to find historically, which may be included in stock market volatility lately, but officials never give up hope. Communications will be important in coming months to ease this transition, and allow markets to digest any unexpected changes. The more gradual the policy, the lower the chance of disruption, even if it's difficult to make everyone happy in the short-term, as the world moves from an 'easing' paradigm into the start of a 'tighter' one. Policy is also very malleable—today's expectations could shift suddenly if the economy slows faster than expected again, for example.

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