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Fed gets serious on inflation — speeds up policy shift

Key takeaways

- The Federal Reserve (Fed) has made it clear with its December 15 meeting minutes, and in the comments of multiple Fed speakers since, that it plans to accelerate the pace of monetary policy normalization to counter inflation rates not seen since the 1980s.

What it may mean for investors

- We discuss the implications for fixed income and for broader markets of this accelerated schedule.

After its initial hawkish pivot in June 2021, which brought forward expected rate lift-off from 2023 to 2022, the Federal Reserve (Fed) has continued to signal its intent to accelerate the removal of its post-COVID-19 ultra-accommodative monetary policy. (This is what the Fed is referring to when it talks about “normalizing policy.”) As growth has remained robust, and inflation has risen to rates not seen since the 1980s (7% CPI in December 2021)[1], the Fed has indicated a growing sense of urgency.

At present, policy remains accommodative, as the Fed is still increasing the size of its balance sheet with monthly purchases of U.S. Treasuries and mortgage-backed securities. But this is about to change. The Fed will very probably cease buying bonds by the end of the first quarter, and the market expects rates to begin to rise around that time, with the first increase in the federal funds rate almost fully priced for the March 15-16 Federal Open Market Committee (FOMC) meeting.

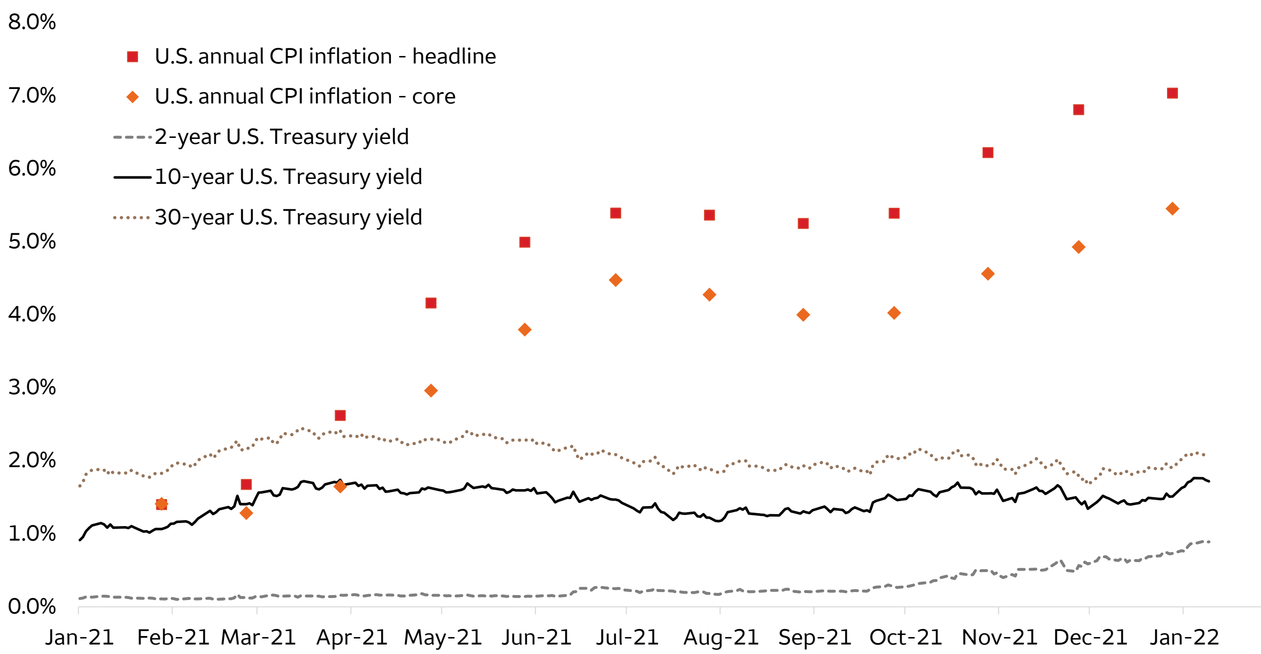
[1] CPI = Consumer Price Inflation, year-over year change

Key events over the past month have convinced financial markets that the Fed is serious about normalizing policy more aggressively in 2022. On December 15, following its last policy meeting of 2021, the Fed announced that it would double the speed of tapering, implying that it will finish expanding the balance sheet by March 2022. Further, median rate projections from Fed officials envisioned three rate increases in 2022 and another three in 2023.

Equally significant was the publication on January 5 of the minutes of that December 15 Fed meeting. Fed staffers presented studies, and Fed officials discussed a range of topics, including: the previous experience of policy normalization, alternative approaches to removing accommodation, timing and sequencing of normalization actions, and the appropriate size and composition of the Fed's balance sheet.

Most important was the idea that the economy is robust enough, and the inflation threat serious enough, to warrant reducing the size of the Fed's balance sheet far sooner than had been the case in 2018. This process, the reverse of "quantitative easing" (QE) bond purchases, has been dubbed "quantitative tightening" (QT). This was a genuine surprise to the market.

Fed speeds up normalization plans as inflation surges



Sources: Bloomberg & Wells Fargo Investment Institute, latest data as of January 12, 2022. CPI = Consumer Price Index.

Since January 5, several Fed officials have communicated in interviews that they expect the first interest-rate increase to occur perhaps as soon as the March 15-16 FOMC meeting, validating the market's current expectation. However, it is our belief that the final number of rate hikes in this cycle will depend on the evolution of inflation rates over the course of the year, whether December's 2021 7% year-on-year inflation rate proves to be a peak, and how quickly and to what extent year-on-year inflation falls as we move through the year and into 2023.

The chart shows the unprecedented disconnect between inflation rates (red dots) and the levels of bond yields (lines). Even if inflation rates move lower in 2022, as we expect, a rising policy rate will cause Treasury yields to climb across the curve. However, the increase may be more pronounced in short-term yields relative to the increase in longer-term yields (effectively flattening the shape of the yield curve). If this flattening process is slower and more moderate than expected, there is a good chance that the Fed's two-pronged normalization (in other words, QT as well as rate increases) may in fact act to prolong the business cycle, in our opinion.

Investment implications

Increases in bond yields can be seen as in line with fundamentals and a solid economy, and this is consistent with our unfavorable rating on long-term fixed income. Fixed income still plays a key role inside portfolios, but we believe investors are better served using fixed income defensively — as a source of income for investors in search for yield but also as a potential portfolio stabilizer when unexpected risks surface.

We favor checking holdings and reducing portfolio concentrations exceeding our guidance in government securities, mortgage-backed securities, and investment grade corporate bonds with long maturities. Instead, we prefer full strategic allocations in intermediate-term fixed income and particularly in corporate bonds with shorter duration; in preferred stock for those investors seeking yield; and in floating rate bonds, as they tend to provide better relative performance than other fixed-income asset classes during a rising rate environment.

Despite some early volatility, most other financial markets have been able to digest the idea of an accelerated policy normalization from the Fed in a relatively positive way. The market consensus appears to accept that it is impossible and undesirable for the Fed to continue with highly accommodative policies as we move past the worst of the pandemic and with inflation surging. Beneath the top-level gyrations in equity indexes, there were signs that the market accepted the Fed's greater urgency and determination in the face of inflation. Signs of genuine flight from risk were mostly absent. For example:

- No excessive flight towards the U.S. dollar or yen as a sign of potential trouble ahead
- No demand for perceived safe-havens as U.S. Treasury yields moved up and not down
- No rotation into defensive equity sectors
- No sell-off in oil or copper markets

In this context, a higher Fed policy rate and rising bond yields can be viewed as a positive, given they are more in line with fundamentals and a solid economy. We continue to favor equities over bonds, U.S. equities over international markets, and U.S. Large Cap and Mid Cap equities. Our sector preferences favor a balance between growth (Information Technology and Communication Services) and cyclicals (Industrials and Financials).

Risks Considerations

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. The prices of small and mid-cap company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Although Treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

In addition to the risks associated with investment in debt securities, a fund's investments in mortgage-backed securities will be subject to prepayment, extension and call risks. Changes in prepayments may significantly affect yield, average life and expected maturity. Extension risk is the risk that rising interest rates will slow the rate at which mortgages are prepaid. Call risk is the risk that If called prior to maturity, similar yielding investments may not be available for the Fund to purchase. These risks may be heightened for longer maturity and duration securities.

There are special risks associated with investing in preferred securities. Preferred securities are subject to interest rate and credit risks. Interest rate risk is the risk that preferred securities will decline in value because of changes in interest rates. Credit risk is the risk that an issuer will default on payments of interest and principal. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

Floating rate notes are subject to interest rate and credit risks, among others. Although the market value of a floating rate note is relatively insensitive to interest rate changes, the income received is highly dependent on the level of the reference rate over the investment's life and total return may be significantly less than anticipated if interest rate expectations are not met. Investors should bear in mind that the amount of interest they receive on the notes may be less than the return they could earn on other investments.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

Definitions

An index is unmanaged and not available for direct investment.

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

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