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The Fed's path to policy normalization

Just as fixed income markets managed to stabilize after the Fed intervened in the wake of the pandemic, we also expect them to react when the Fed begins to remove stimulus.

Deeper analysis of investment trends and topics **March 11 2022**

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Key takeaways

- Federal Reserve (Fed) tightening of monetary policy via higher rates and balance sheet runoff is on the horizon, but we believe this time it may look different from previous cycles.
- The Fed is currently navigating in an economic and financial environment that is more complicated than any other in recent history. We believe that the number of rate hikes in 2022 remains flexible and dependent on how the economy, the pandemic, and inflation levels continue to evolve.
- The yield curve has been — and will continue to be — the most important indicator we watch during Fed tightening cycles and rising rate environments. Fixed income still plays a key role inside a portfolio for investors in search for yield, but also as a potential stabilizer when unexpected risks surface.

"There was a time, not too long ago, when central banking was considered to be a rather boring and unexciting occupation. In the era of the 'Great Moderation,' mostly seen as the period between the mid-1980s and the beginning of the global financial crisis, inflation was tamed and macroeconomic volatility was contained. Some thought that monetary policy could effectively be placed on auto-pilot. I can confidently say that this time has passed."

— Mario Draghi, prime minister of Italy and former president of the European Central Bank

Over the past two years, actions from the Fed pushed interest rates toward the zero bound and added over $1 trillion of liquidity to a financial sector that was already flush with reserves. Fiscal stimulus for pandemic relief provided another nearly $6 trillion. Coordinated monetary and fiscal stimulus has been a defining feature of economic policy in the U.S. in the wake of COVID-19, helping combat the lingering disruptions from the pandemic.

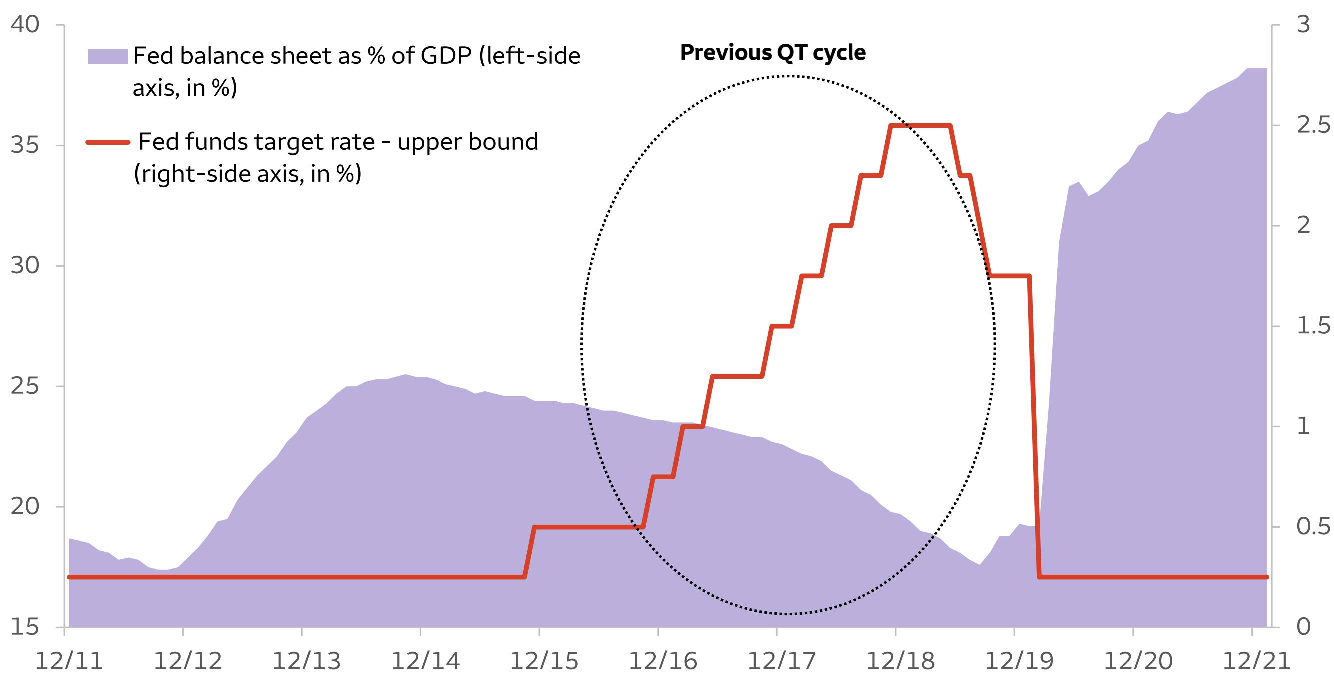
This recipe, however, is nothing new, as policymakers have taken a similar approach in the past. In the 1920s following World War I and the 1918 Spanish flu pandemic, in the 1930s after the Great Depression, in the 1940s after World War II, and most recently in 2008 after the global financial crisis, we have observed a common pattern of policymaker intervention. In each case, higher issuance from the U.S. Treasury to fund fiscal stimulus has been combined with the Fed's low-interest-rate policy and government securities purchases to help reinvigorate the economy.

Yet, history has also shown that once the economy has rebounded, conflicting macroeconomic forces may intrude. Higher inflation, larger government deficits, and asset bubbles have often been consequences of easy financial conditions. Policymakers typically respond by reversing course and tightening financial conditions, which in many cases have led to asset-price corrections. We believe that the U.S. economy is already in a transition period, which most likely will continue throughout 2022, as economic growth slows down, labor markets improve, and inflation levels remain elevated.

That similar post-crisis pattern is coming together again as the most severe risks of the pandemic appear to be receding. Indeed, the world today looks very different than the world before the pandemic. The U.S. economy is currently experiencing the highest inflation levels in decades, while labor markets are improving and economic growth remains above recent averages.

Persistently high inflation has forced the Fed to act more swiftly than previously anticipated, and the Fed's rapid pivot since December has had repercussions in financial markets. So far this year, bond and stock prices have declined while measures of volatility have increased. However, we do not believe that a correction in financial markets will carry enough weight to derail the Fed from its objective to tackle inflation. In our opinion, the Fed's journey toward policy normalization has just begun. But this process will most likely look very different than the first time the Fed implemented quantitative tightening (QT).

Chart 1. Recent monetary tightening



Sources: Bloomberg and Wells Fargo Investment Institute as of February 18, 2022. Monthly data from December 2011 to December 2021.

The Fed in action — How do tightening cycles work?

In essence, a tightening cycle would be just the opposite of what we have gone through over the past two years. We expect the Fed to initiate a period of rising policy rates coupled with a shrinking of its balance sheet, either by letting maturing bonds roll-off (similar to what the Fed did from 2017 to mid-2019) or by proactively selling bonds (see chart 1). As policy-makers embark on this path, financial conditions may begin to tighten if the cost of borrowing increases and available liquidity begins to decline.

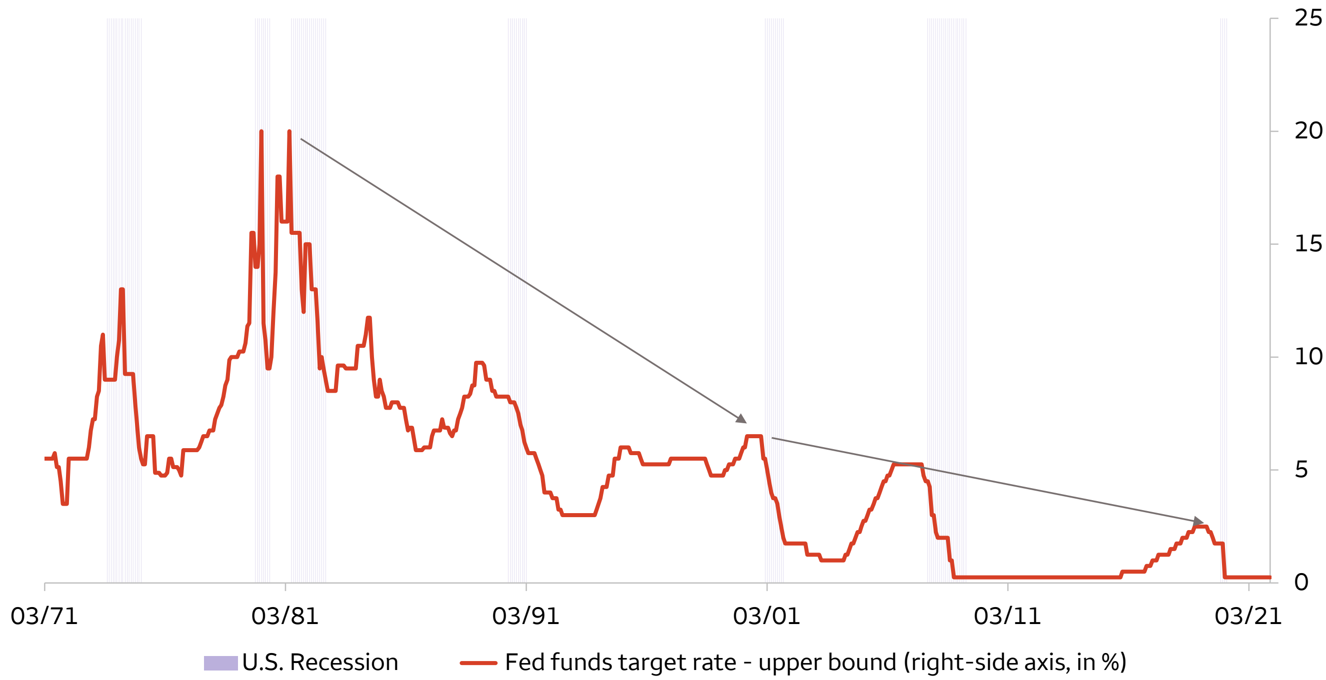
All of these factors combined could then begin to compound across the economy, affecting the behaviors of consumers, businesses, and investors. Capital flows may also change directions as financial participants reprice their investment options, given the new levels of interest rates and as we move toward the middle stage of the economic expansion.

Raising policy interest rates:

Theoretically, the Fed's goal is to align the level of policy interest rates with the level of economic growth, effectively implementing a neutral interest rate (in other words, a policy rate that is neither easing nor tightening). However, in practice, calibrating the optimal level of policy interest rates is a difficult task. Many factors — including demographics, productivity, demand for more stable assets (such as bonds), and capital efficiency — come into play to determine the appropriate level of interest rates in an economy.

We believe that the number of rate hikes in 2022 remains flexible and dependent on how the economy, the pandemic, and inflation levels continue to evolve. Determining the final level of policy interest rates is a complex exercise, but in general terms, we can confirm that over the past four decades, policy interest rates have topped out at progressively lower levels during monetary policy tightening, eventually pushing the economy into a recession (Chart 2). The decades-long secular trend of declining inflation, nominal interest rates, and a general increase in debt issuance has pushed the overall level of interest rates in the economy well below long-term averages.

Chart 2. Falling peaks in rates — the Fed has tended to overshoot



Sources: Bloomberg and Wells Fargo Investment Institute as of February 18, 2022. Monthly data from March 1971 to January 2022.

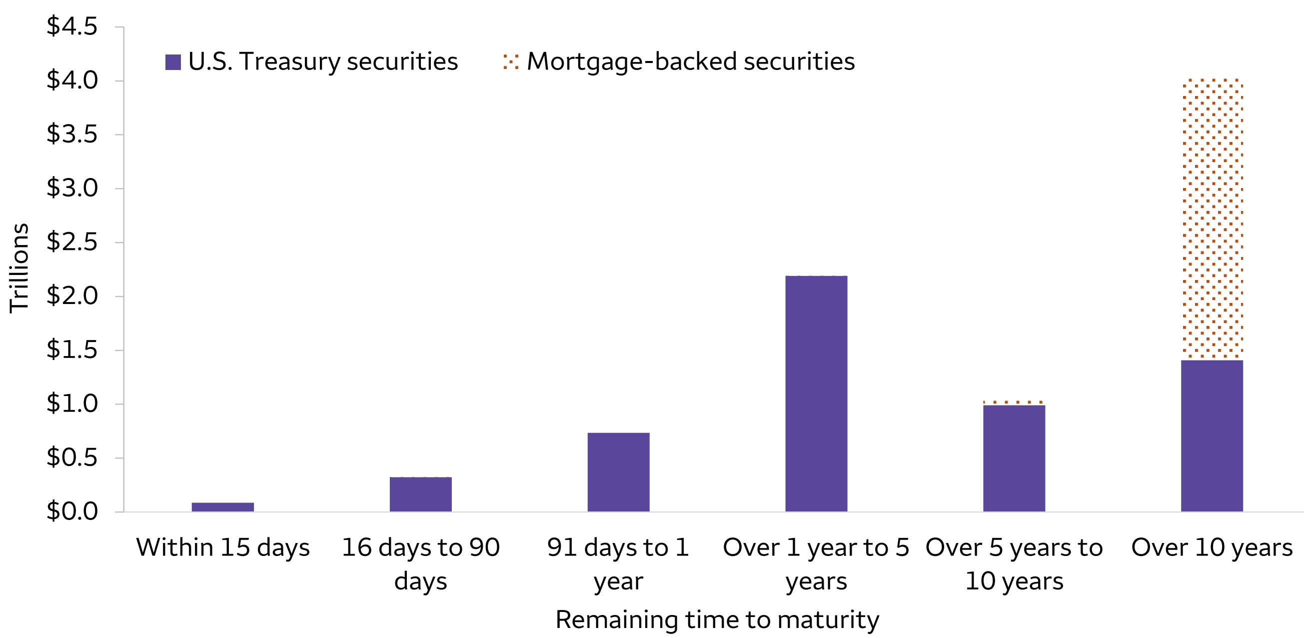
Downsizing the balance sheet:

The Fed has signaled that after it begins raising interest rates, it will then move on to normalize the size of its balance sheet. This is often referred to as quantitative tightening (QT). Recent Fed meeting minutes showed signs that Fed officials are planning to allow balance sheet runoff to occur sooner than they did in 2017. Back then, the idea was that QT would not cause a major disruption in economic activity, if done slowly, given the positive momentum in employment and economic growth. In the words of former Fed chair Janet Yellen, the effects of QT would be analogous to "watching paint dry."

When the Fed began QT in 2017, its intent was to allow bonds to mature off its balance sheet. It began with a combined cap of $10 billion ($6 billion for Treasuries and $4 billion for mortgage-backed securities [MBS]), and the caps increased by those amounts each quarter until they reached $30 billion per month and $20 billion per month, respectively. However, in May of 2019, the Fed reduced those caps, and by the end of July, announced the end of the balance sheet runoff earlier than previously indicated. Shortly after, in September, a key short-term interest rate climbed too aggressively, signaling that too much liquidity had been drained from the financial system.

Given the size of the Fed's balance sheet today, we believe the amounts of the runoff this time will be much larger than in 2017. By allowing faster roll-off using higher caps, the balance sheet could shrink faster toward pre-pandemic levels. Although the initial cap has not been set yet, the relatively short duration of the Fed's holdings suggest that the Fed could allow the balance sheet to shrink quickly, as a significant portion of its holdings will mature in the next one-to-five years (Chart 3). Some uncertainty still surrounds the decision on the pace. Keep in mind that, prior to 2017, the Fed's balance sheet never declined for more than two consecutive quarters since 1967.

Chart 3. QT in 2022 could occur at a faster pace than QT in 2017



Sources: Federal Reserve, Table H.4.1 Factors affecting reserve balances. Current maturity distribution of the Fed's U.S. Treasury and Mortgage-backed securities holdings, as of February 17, 2022.

Why this time is different:

U.S. inflation is at the highest level since 1982. We believe the Fed's hand has been forced to act swiftly and they will attempt to raise rates several times in 2022. However, after some hikes, the Fed could take a more cautious approach. An overly aggressive Fed policy may not be required as pandemic-related swings in spending, above-average economic growth and stubbornly high inflation levels are likely to subside in the next two years.

Also, the previous episode of balance sheet reduction was supposed to happen in the background — playing no major role in the conducting of monetary policy. This time around, QT is a mechanism to signal that the Fed means to remove its previous monetary stimulus from the economy.

Lastly, in the previous round of QT, some investors believe that liquidity was drained from the financial system at a fast pace. However, this time, given the large of amount of reserves currently available, we do not believe that balance sheet run-off will have such a significant impact. Even at a cap rate of $90 billion per month, we don't believe that the balance sheet run-off would have tightening effects until mid-2023. Also, the Fed could decide to start at a lower cap rate, which would effectively delay tightening effects.

Risks of potential Fed policy missteps over the next two years

As mentioned previously in the report, the Fed is currently navigating in an economic and financial environment that is more complicated than any other in recent history. Its main risk is shifting unintentionally from "hero" to "villain" of the U.S. economy by implementing monetary policies that are too restrictive. We expect U.S. economic growth to slow in 2022 from the strong pace of the past two years. But if the Fed removes so much liquidity that scarcity of funds undercuts economic growth, investors could turn to blame policymakers.

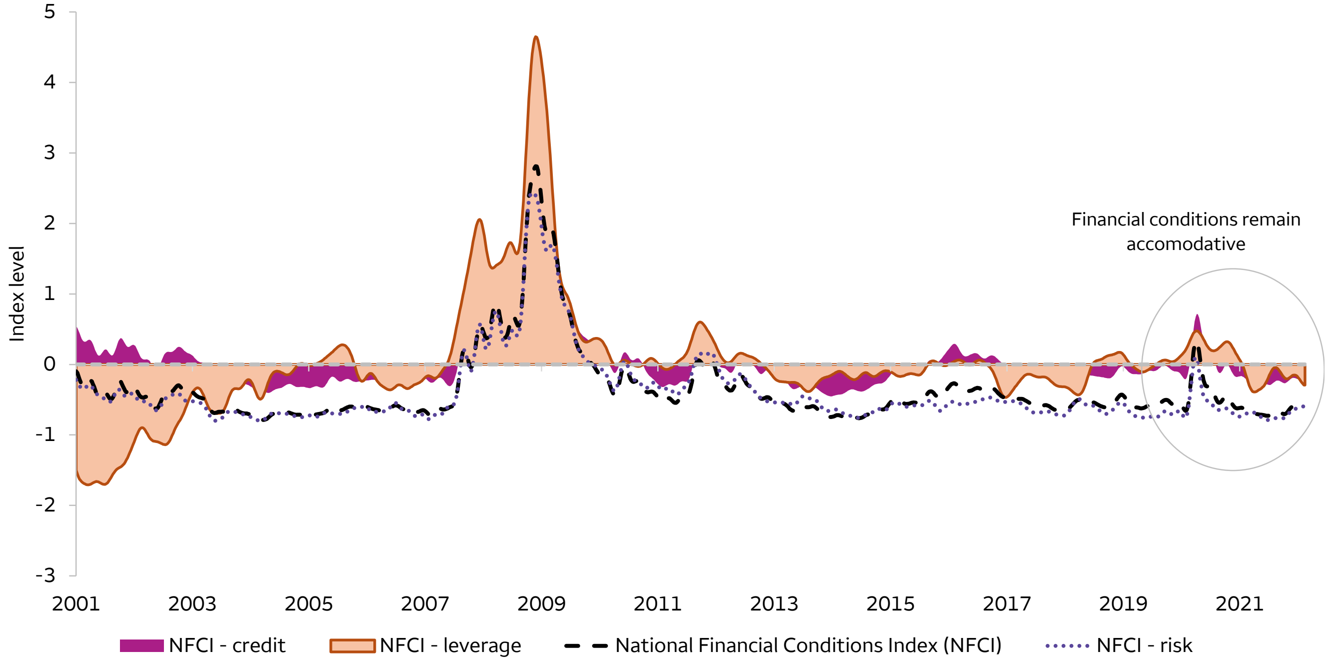
We don't believe that current financial conditions will overly tighten, nor do we expect to see immediate liquidity problems as the Fed begins to normalize monetary policy. But if inflation continues elevated, and businesses and consumers begin to expect even higher future inflation, the Fed may tighten more aggressively. In this first scenario, the risk is that tightening policy could cause economic activity to weaken and unemployment to rise, just when the stubbornly high inflation begins to yield ground. Ultimately, over-tightening liquidity could slow inflation below the Fed's longer-term target.

The most likely scenario, in our view, is that inflation eventually decelerates. In this case, we believe the Fed would only hike six times in 2022, and then would be able to continue to lift rates and shrink the balance sheet at a slower pace that depends more on the evolution of the economy over the balance of the economic expansion. This more cautious approach should allow the Fed to avoid tightening excessively, while sticking to its new flexible inflation average target framework that allows inflation to run at or slightly above its longer-term target of 2%.

Another scenario that is beginning to gain traction is one where inflation peaks around current levels but declines to a range that is still too high for the Fed (somewhere around 4%-5%). In this case, the Fed may choose to ramp up on tightening but not as much as in the first scenario, perhaps avoiding a recession but still creating some pain in equity and fixed income markets.

Although all of these risks linger in the background as the Fed begins to normalize policy, we believe that the economy will be able to withstand tighter economic policy throughout 2022. Financial conditions still remain extremely accommodative (chart 4). We expect the federal funds rate to remain closer to the zero level than to the Fed's estimate of its longer-run neutral rate of 2.5% (which also happens to be the terminal interest rate level of the previous hiking cycle). Longer-term interest rates are also still very low when compared to historical averages and well below zero after adjusting for inflation. (This is what economists refer to as real rates.)

Chart 4. Although interest rates are rising, easy financial conditions are still available

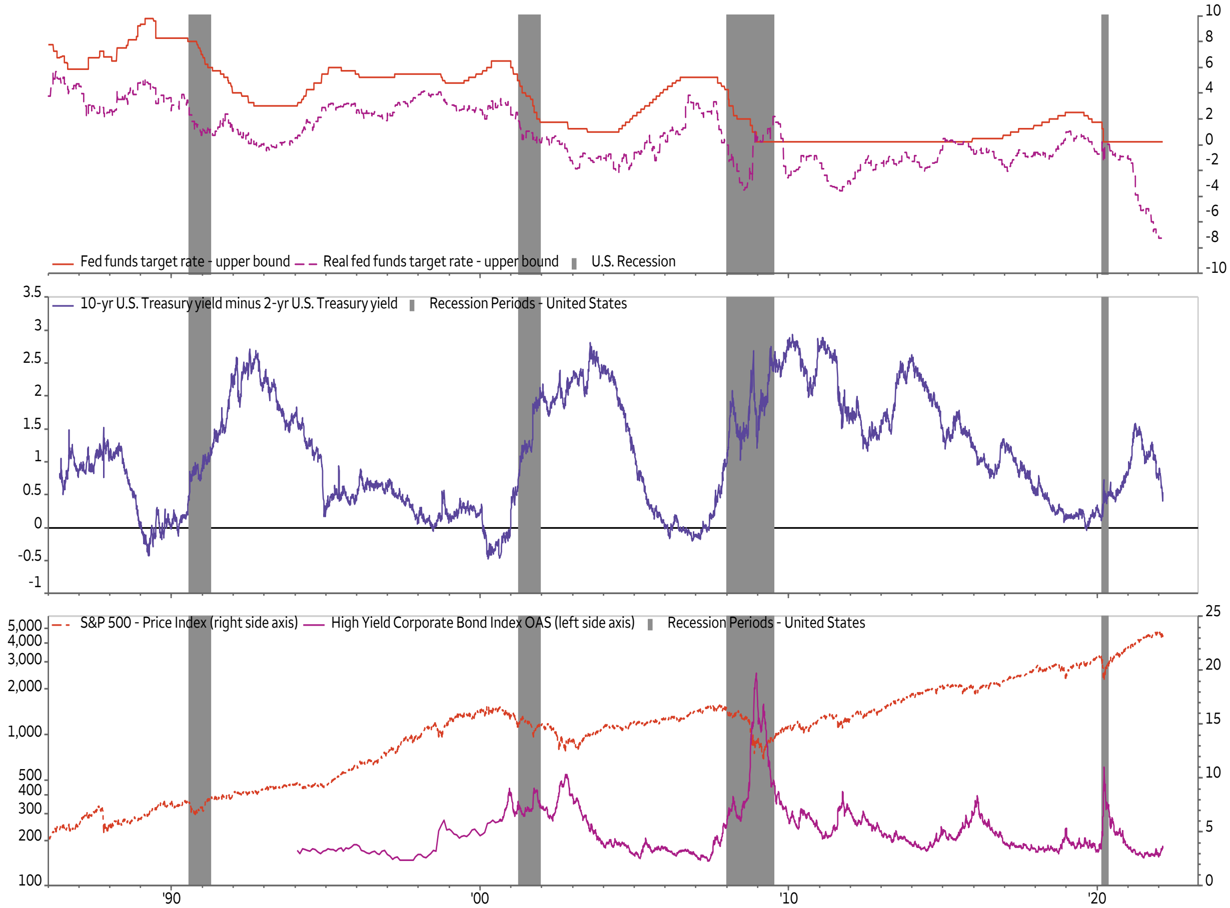


Sources: Federal Reserve Bank of Chicago. Weekly data not seasonally adjusted from 01/05/2001 to 02/18/2022. The Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems. The NFCI is constructed to have an average value of zero and a standard deviation of one over a sample period extending back to 1971. Positive values of the NFCI have been historically associated with tighter-than-average financial conditions, while negative values have been historically associated with looser-than-average financial conditions. This figure plots the NFCI, along with contributions to the index from the three categories of financial indicators (risk, credit, and leverage). An index is unmanaged and not available for direct investment.

Effects of policy tightening on fixed income markets

Just as fixed income markets managed to stabilize after the Fed intervened in the wake of the pandemic, looking ahead we also expect them to react when the Fed begins to remove stimulus. As a general rule, interest-rate movements are usually at the forefront, as they are highly sensitive to changes in monetary policy. Historically, when policy has been stimulative, the yield curve steepened — long-term rates generally rose faster than short-term rates — but as the market started to perceive that a change from the Fed was on the horizon, the relative movements across maturities generally reversed and the yield curve flattened. Chart 5 illustrates this tendency across previous cycles of rate movements as the economy moves through its phases of expansion and contraction. This has also been the case in the current cycle. As of the time of this writing, the Fed has not even yet started raising policy rates and the U.S. Treasury yield curve has already managed to change its shape from steepening towards flattening.

Chart 5. Tightening cycles in different periods but similar script



Sources: Bloomberg and Wells Fargo Investment Institute as of February 18, 2022. Daily data from January 1, 1986 to February 18, 2022. **Past performance is no guarantee of future results**. Current performance may be higher or lower than the performance quoted above. Yields and returns will fluctuate as market conditions change. Bottom chart has the S&P 500 PR Index and the Bloomberg High Yield Corporate Bond Index option-adjusted spreads. An index is unmanaged and not available for direct investment.

In the current cycle, the fixed income sector has been very slow to react to the higher economic growth and inflation. Although nominal yields have increased, real yields (nominal yields adjusted for inflation) remain in negative territory, and the overall level of interest rates in the economy remains well below long-term averages. Fixed-income returns tend to underperform during Fed tightening cycles as interest rates climb, and we believe there could be further underperformance in the current tightening cycle.

Table 1. Fixed income performance during tightening cycles

Fixed income sector	Fed tightening cycle (return %) 12/31/1993 - 12/31/1994 (Annualized)	Taper tantrum (return %) 4/30/2013 - 12/31/2013 (Cumulative)	Fed tightening cycle (return %) 12/14/2016 - 12/19/2018 (Annualized)	Current (return %) 12/31/2020 - 2/22/2022 (Annualized)
U.S. 1-3 Month T-bills	4.42	0.02	1.28	0.04
U.S Treasuries	-3.00	-3.46	1.54	-4.70
Short-term fixed income	1.03	0.31	1.11	-1.58
Intermediate-term fixed income	-1.64	-2.37	1.59	-4.43
Long-term fixed income	-6.09	-10.41	3.93	-8.42
U.S. Taxable IG fixed income	-2.95	-2.91	1.86	-4.35
Mortgage backed securities	-0.81	-1.88	1.62	-3.37
U.S Corporate bonds	-3.96	-3.27	2.45	-5.14
U.S. High Yield Corporate bonds	0.20	2.75	3.32	0.95
Municipal bonds	-3.16	-3.79	3.30	-1.52
Preferred stock	-	-4.27	2.35	-1.72
Leveraged loans	-	2.52	2.91	5.00

	Fed tightening cycle (rate of change)	Taper tantrum (rate of change)	Fed tightening cycle (rate of change)	Current (rate of change)
Change in 10-yr U.S. Treasury yields	2.03%	1.36%	0.18%	1.03%
Change in the Federal Funds rate	2.50%	0.00%	1.75%	0.00%
Change in High Yield Option Adjusted Spreads	-0.03%	-0.50%	0.74%	0.01%

Sources: Bloomberg and Wells Fargo Investment Institute as of February 22, 2022**. Past performance is no guarantee of future results**. Current performance may be higher or lower than the performance quoted above. Yields and returns will fluctuate as market conditions change. An index is not managed and not available for direct investment. See end of report for index definitions.

The current interest-rate cycle could begin to show some resemblance to the tightening cycle of 1994, as Fed officials are anticipating the need to tighten aggressively and in a shorter period-of-time, with an expected total rate of change in the federal funds rate of 2.5%. In 1994, the Fed managed to slow down the economy without driving it into a recession. Fixed-income markets suffered, but in the following two years, interest rates managed to decline, allowing performance to recover.

From the table above, we can observe that three fixed-income sectors that have managed to perform best during previous tightening cycles are leveraged loans, high-yield corporate bonds, and short-term fixed income. Although past performance is not a guarantee of future results, we believe that these sectors are better suited to withstand the upcoming Fed tightening. On the other hand, the sectors with longer duration exposure were the ones that declined the most.[1]

1. A measure of the sensitivity of the price of a bond due to a change in interest rates.

Implications for investors

In our opinion, the yield curve has been and will continue to be the most important indicator to watch during Fed tightening cycles and rising rate environments.

Markets have moved extremely fast, well before the first rate hike of the current cycle has even occurred. We expect heightened volatility in rates as the market continues to digest incoming economic data, with inflation remaining a wild card that will end up influencing the Fed's hand the most.

Four fixed-income portfolio ideas investors may want to consider for a rising rate environment:

- Use fixed income defensively. Fixed income still plays a key role inside portfolios, but, while the Fed is removing stimulus, we favor using fixed income as a source of income and as potential portfolio stabilizer when unexpected risks surface.
- Review portfolio holdings and consider reducing portfolio concentrations exceeding our guidance in U.S. government securities, investment grade corporate bonds with long maturities, and mortgage-backed securities.
- Maintain full strategic allocations in intermediate-term fixed income, and particularly in high-yield corporate bonds; in preferred stock for those investors seeking yield; and in floating rate bonds (leveraged loans for example) as they tend to provide better relative performance than other fixed income asset classes during a rising rate environment and a Fed tightening cycle.
- Maintain durations at or slightly below selected fixed income benchmarks.

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In his role, Mr. Alvarado researches and analyzes economic and market trends for the investment strategy team. He contributes to several WFII publications, including Global Investment Strategy reports, white papers, and special reports. In addition, he helps maintain the WFII library of economic and market charts.

Mr. Alvarado joined the investment strategy team in 2012 from Wells Fargo Advisors where he served as a client service associate, supporting the sales and trading functions for brokerage clients.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. Income from **municipal** securities is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT). **Floating rate securities** are generally below investment grade quality ("high-yield securities or "junk" bonds) and should be viewed as speculative. Investors should review their ability to assume the risks associated with investments which utilize such securities. In addition to the risks associated with investment in debt securities, 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. 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. **Treasury Inflation-Protected Securities (TIPS)** are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until 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.

Index Definitions

Cash Alternatives/Treasury Bills. **Bloomberg U.S. Treasury Bills (1–3M) Index** is representative of money markets.

U.S. Treasury. **Bloomberg U.S. Treasury Index** includes public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Short Term Taxable Fixed Income. **Bloomberg U.S. Aggregate 1-3 Year Bond Index** is the one to three year component of the Bloomberg U.S. Aggregate Bond Index, which represents fixed-income securities that are SEC-registered, taxable, dollar-denominated, and investment-grade.

Intermediate Term Taxable Fixed Income. **Bloomberg U.S. Aggregate 5-7 Year Bond Index** is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 5-7 years.

Long Term Taxable Fixed Income. **Bloomberg U.S. Aggregate 10+ Year Bond Index** is composed of the Bloomberg U.S. Government/Credit Index and the Bloomberg U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 10 years or more.

U.S. Taxable Investment Grade Fixed Income. **Bloomberg U.S. Aggregate Bond Index** is a broad-based measure of the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

U.S. Mortgage-backed securities. **Bloomberg US Mortgage Backed Securities (MBS) Index** tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

U.S. Investment Grade Corporate Fixed Income. **Bloomberg U.S. Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

U.S. High Yield Corporate Fixed Income. **Bloomberg U.S. Corporate High Yield Index** covers the universe of fixed-rate, noninvestment-grade debt.

U.S. Municipal Bond. **Bloomberg Municipal Index** is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

Preferred Stock. **S&P U.S. Preferred Stock Index** is designed to measure the performance of the U.S. preferred stock market. Preferred stocks pay dividends at a specified rate and receive preference over common stocks in terms of dividend payments and liquidation of assets.

Leveraged Loans. **S&P/LSTA Leveraged Loan Index** is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads and interest payments.

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