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Fed Turns Much More Hawkish

The minutes from the December FOMC showed the Federal Reserve is preparing for an accelerated pace of policy normalization in 2022. After announcing at its December meeting that it would accelerate its tapering of asset purchases and signaling as many as three rate hikes this year, the minutes showed that the Fed is also already looking to drawing down its balance sheet at a “faster” pace than previous periods of normalization.

With the labor market appearing in very strong shape—the recent JOLTS report for November and December ADP private sector payrolls report highlighted a strong end to 2021—and inflation remaining at high levels, the barriers to policy normalization appear minimal. Our expectation now is that the Fed will follow through with three rate hikes in 2022 once it has completed its tapering of asset purchases by the end of Q1 at its accelerated pace. We expect the Fed to raise rates by 25bps in Q2, likely at the May meeting, followed by two additional 25bps hikes in Q3 and Q4, bringing policy rates to 1% by the end of the year.

While we do not expect that the US economy will suffer substantially from the effects of the Omicron variant of Covid-19, the risk of a new more virulent strain of the virus is an exogenous downside risk. We would assign more upside risk to our rates forecasts though should inflation continue to run high, particularly in H2 2022 if many of the drivers of inflation in 2021, such as high energy prices or supply chain disruptions, remain in place.

A more open question is when the Fed would begin to run down its balance sheet which ended 2021 at around USD 8.8trn, nearly double its post financial crisis peak of USD 4.5trn in 2014. The minutes gave no clear indication on when running down the balance sheet would begin or at what pace but the fact that it was discussed, even amid the downside risks to growth and employment poised by the persistence of the Covid-19 pandemic, reflects that the Fed has become much more aggressive in its normalization outlook than it was only a few months earlier. ■

(Source: Emirates NBD Research)

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