FOMC minutes: Setting the stage for QT and a tight monetary regime

- **The release of the FOMC minutes for the policy meeting that was held from 15-16 March 2022 reaffirmed our expectations of a front-loading of tightening of US monetary policy**
- **The minutes showed that consensus within the committee had been reached to launch QT along with a possible 50bps rate hike in the May policy meeting**
- **The emphasis was on continuing to fight off inflation pressures and subsequently the central bank will move forward to push the policy rate back to the neutral territory and possibly restrictive territory**
- **The FOMC is maintaining its view of a soft-landing of the US economy, although we see a sharp slowdown setting in place in 2023**
- **We maintain that the FOMC will raise rates by 50bps in May along with the QT announcement. This could be followed by another 50bps rate hike in June and another 100-125bps over the remainder of 2022. A further 50-75bps rate hike in 2023 is likely**

QT plans clarified: The most important takeaway from this round of the minutes was the clarification on QT. The minutes showed that participants had agreed upon rolling off the balance sheet at a pace of USD 95bn per month. Of which, caps of USD 60bn will be done for US treasury securities and USD 35bn for mortgage backed securities. In order to accelerate balance sheet reduction, the Fed will top the roll-off of US treasuries with rolling off treasury bills in months in which less than USD 60bn are scheduled to mature. **The full caps could be phased in over a three month period but also be extended beyond the time frame depending on market conditions. Hence, cumulatively the balance sheet run-off should reach about USD 95bn per month that could come in place in a staggered manner on a monthly basis.**

The pace will be much faster than the USD 50bn per month that was seen during the peak of QT during the 2017-19 period. The minutes also showed that outright sales of MBS securities could be considered at a later date to ensure that the SOMA asset holdings comprises mainly of treasury securities. However, there was no discussion of outright sales in treasury securities.

Aggressive rate hikes in store: The minutes showed that participants would have hiked rates by 50bps in the March policy meeting itself were it not for the uncertainty created by the Russia-Ukraine conflict. However, the minutes showed that there was a strong backing for a 50bps rate hike as early as in the upcoming policy meeting in store.

Inflation remains the primary concern: The minutes showed that the underlying focus for the FOMC will remain on tackling the inflationary risks and pressures in the economy. Several areas of inflation sources were discussed: (a) strong aggregate demand, (b) sharp increase in energy and commodity prices, (c) tight labour market and (d) supply-chain disruptions given the lockdowns that have started in China. **The minutes showed that 'several participants judged that the upside risk to inflation associated with the war appeared more significant than the downside risk to growth' implying that monetary tightening will remain in place. Hence, 'participants judged that it would be appropriate to move the stance of monetary policy toward a neutral posture expeditiously. They also noted that, depending on economic and financial developments, a move to a tighter policy stance could be warranted.'**

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Economy will remain in good shape: While the FOMC is expected to move forward to tighten policy aggressively, the minutes showed that participants continued to see a fairly robust outlook with the economy expected to grow above its trend pace. GDP growth projections for 2022 were revised lower reflecting the effects of the Russia-Ukraine conflict and rise in global commodity prices but the economy was expected to hold up. The labour market was also showing signs of continued tightness that most participants expect to remain in place. Several business contacts continued to report difficulties in hiring and retaining workers. Labour force participation was also expected to improve going forward. **In short, the FOMC is sticking with its view of a soft-landing, even as it moves forward to tighten policy both in the form of rate hikes and balance sheet reduction.** However, we would differ in our view and we see risk of a sharp slowdown going in to 2023 and 2024 as the lagged effect of monetary tightening starts to bite in to the leveraged sectors and interest rate sensitive sectors of the economy.

Outlook: Tightening plans for 2022 to be maintained: **For the upcoming May policy meeting, we maintain our view of a 50bps rate hike and QT announcement of a USD 95bn run-off in the balance sheet.** We think that the pace of QT could accelerate to possibly USD 110bn after a three month period. Cumulatively, we see a USD 1.1tn reduction in the size of the FOMC's balance sheet over the next one year.

In terms of rate hikes, we would not rule out another 50bps rate hike in the June policy meeting. We see 225bps to 250bps worth of cumulative rate hikes over 2022 and another 50-75bps worth of rate hikes over 2023. The fed funds futures market is pricing in eight to nine 25bps worth of rate hikes over the remainder of 2022. Given the sharp one-off shock that has taken place in terms of global commodity prices, we expect US PCE inflation to remain elevated over 2022 much above the FOMC's desired levels. Only once the effects of the tightening takes hold will it possibly start to show up in PCE inflation prints in 2023. **The upshot is that the elevated inflation readings will allow the FOMC to move forward with its plans to front-load monetary tightening in 2022.** The slowdown in the economy will only show up more prominently in 2023.

Market impact: The market had to a greater degree priced in a possible QT announcement in the minutes in response to Fed Governor Brainard's guidance provided earlier this week.

The QT announcement has to a limited degree reversed the inversion of the yield curve that was seen with spread between the UST 10 year and UST 2 year moving in to +13bps as compared to -7bps prior to the release of the minutes. In the near-term, we see the yield curve re-steepening as investors price in QT that will be concentrated in the longer-segments of the curve. However, we maintain our base-case view of the shape of the yield curve inverting that might become more pronounced in Q42022 once growth concerns re-surface.

The aggressive tightening path provided by the FOMC will likely result in more USD strength in the near-term. We see an upside possibility of 100.50 opening up for the DXY in H12022 before it trades lower in H22022 as investors re-focus on ECB's normalization plans. USD/EM will likely to trade with an upside bias across the board pricing in a reduction in USD liquidity in the global markets. There was sharp depreciation in EM currencies against the USD that was seen during 2018 at the peak of the US monetary policy tightening cycle when the Fed was both hiking rates aggressively and draining liquidity via its QT framework. A similar trend is possible going forward.

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