27 January 2022

Fed readies for March interest rate hike to fight inflation surge

Key Highlights

- **Fed to keep the rate unchanged** at historically low levels between 0% and 0.25%, however it also stated that it would be **appropriate to raise the rate "soon" with inflation well above 2%** and a strong labor market.
- Fed **expects to end its pandemic-era bond-buying program by early March** in light of the progress of the economic recovery.
- Fed has outlined a **plan to begin reducing nearly $9 trillion balance sheet** after the first interest-rate hike.

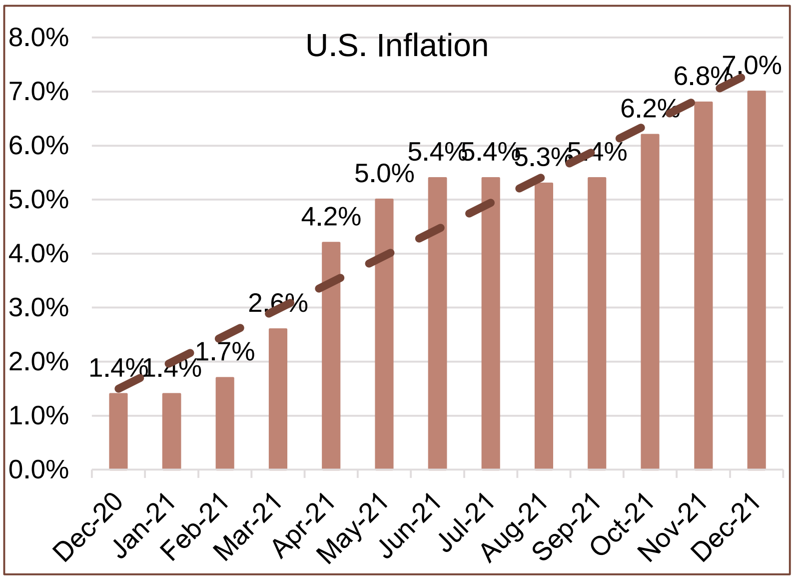
Key Highlights

- In line with expectation Fed on Monday said it is **likely to hike interest rates in March** and **didn't rule out moving at every meeting** to tackle the highest inflation in a decade.
- Committee decided to **keep the target range for the federal funds rate at 0 to 0.25%** in an effort to **achieve maximum employment** and **inflation at the rate of 2%** over the longer run.
- Fed would be **prepared to adjust the stance of monetary policy as appropriate** if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on **public health, labour market conditions, inflation pressures and inflation expectations, and financial and international developments.**
- The Committee decided to continue to **reduce the monthly pace of its net asset purchases**, bringing them to an end in early March.
- Beginning in February, the Committee will **increase its holdings of Treasury securities by at least $20 billion per month** and of agency mortgage-backed securities by at least $10 billion per month.
- In a separate statement, the Fed said it expects the **process of balance-sheet reduction will commence after it has begun raising rates**. The Fed's balance sheet stands at nearly $8.9 trillion, more than double its size before officials began massive asset

To Summarize

Fed is moving much quicker than it once expected to, mainly prompted by the failure to curb inflation as anticipated amid robust demand, supply chains imbalances and tightening labor markets. Investors pushed their expectations for rate increases following the meeting and now **project the Fed's policy rate to end the year between 1.25% and 1.5%.** Fed is also outlining principle to shrink its balance sheet as it stands at nearly $8.9 trillion, more than double its size before it began pumping money into the system in an effort to avert an economic meltdown in the wake of the COVID-19 pandemic.

Inflation zoomed near 4 decades high in December 2021 to 7%



Source: tradingeconomics.com

To Conclude

Hawkish commentary from the US central bank spooked the market. As a result of the Fed's tightening monetary policy, **India's benchmark 10-year bond yield surged to 6.75%, highest level since Dec 2019**, i.e., in over 2 years. As Powell spoke the yield on 10-year US Treasury notes rose sharply and stocks fell. The US Dollar Index soared against most major currencies. Global equity markets have remained on the edge ahead of the US central bank's two-day meeting that started on 25th January 2022. The fall in the Indian markets is in line with global markets and **Indian equity markets have discounted the possible hike in rates by the US central bank**.

We believe **market may remain volatile on back of interest rate hike by Fed** and ahead of announcement of the Union Budget 2022-23 on February 1. Investors should **follow the desired asset allocation** to avoid unfavourable portfolio outcomes in case of any volatility that flows in the Indian markets due to tapering.

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