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Rate Hikes Finally on the Way

The Federal Reserve's policy statement from last week plus Jerome Powell's post-meeting press conference made it abundantly clear it is ready to start raising short-term interest rates in March.

As of early this morning, the futures market for federal funds was pricing in five rate hikes (of 25 basis points each) in 2022. We think that many rate hikes are warranted; we'd even support more. The Fed is badly behind the inflation-fighting curve. The Consumer Prices Index rose 7.0% in 2021, the largest increase for any calendar year since 1981. Meanwhile, commodity prices continue to rise.

However, we're still skeptical the Fed will move as aggressively as the financial markets are pricing in. If the Fed were really serious about the inflation fight, why didn't it announce a sudden and early end to Quantitative Easing last week? Instead, the Fed *maintained* QE, which increases the size of its balance sheet, even as it released a set of "principles" for reducing the size of the balance sheet.

Think about how absurd the current situation is. Maintaining QE while signaling it will soon start Quantitative Tightening is like deciding to keep digging a hole deeper, even though you already know that in an hour you're going to take all the dirt you dug up and use it to fill the same hole back in. Why not just stop digging now!

Either way, we think QT starts around mid-year and the Fed will be more aggressive about it than it was back in 2017-19, when the fastest pace of QT was about $50 billion per month. The best reason to implement a larger QT is that the Fed needs to counteract the excessive growth in the M2 measure of the money supply that is the root cause of higher inflation. Unfortunately, the Fed is still not focused on reducing M2 as a policy goal.

Instead, we think the Fed will pursue a robust pace of QT for other reasons. First, the Fed would use QT as a signal of its commitment to keep lifting rates, knowing that market conditions may, from time to time, make it temporarily tougher for the Fed to hike. Second, the Fed thinks selling off longer-maturity securities could modestly lift long-term interest rates, creating more room for it to raise short-term rates without inverting the yield curve.

And third, if the Fed doesn't substantially reduce the balance sheet, it could be a position in a few years where it's paying large financial institutions around $100 billion per year. That's what would happen if the banks are still holding $4 trillion in Fed reserves while short-term rates have hit 2.5%. No Fed chief wants to explain to Congress why it's paying the biggest US banks $100 billion per year.

The bottom line is that the Fed has its work cut out for it. This won't be a one-year job, or even two. Wrestling inflation back under control may take several years. The sooner the Fed focuses its attention on M2 and renews its respect for Milton Friedman the easier that job will be.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-31 / 9:00 am	Chicago PMI – Jan	61.8	**61.8**	65.2	64.3
2-1 / 9:00 am	ISM Index – Jan	57.5	**58.0**		58.8
9:00 am	Construction Spending – Dec	+0.6%	**+0.3%**		+0.4%
afternoon	Total Car/Truck Sales – Jan	12.9 Mil	**14.7 Mil**		12.4 Mil
afternoon	Domestic Car/Truck Sales – Jan	10.4 Mil	**11.5 Mil**		9.9 Mil
2-3 / 7:30 am	Initial Claims – Jan 30	245K	**250K**		260K
7:30 am	Q4 Non-Farm Productivity	+3.3%	**+5.1%**		-5.2%
7:30 am	Q4 Unit Labor Costs	+1.0%	**+0.9%**		+9.6%
9:00 am	ISM Non Mfg Index – Jan	59.5	**60.1**		62.3
9:00 am	Factory Orders – Nov	-0.4%	**-1.0%**		+1.6%
2-4 / 7:30 am	Non-Farm Payrolls - Jan	150K	**175K**		199K
7:30 am	Private Payrolls – Jan	113K	**185K**		211K
7:30 am	Manufacturing Payrolls – Jan	23K	**25K**		3.9%
7:30 am	Unemployment Rate – Jan	3.9%	**3.8%**		+0.8%
7:30 am	Average Hourly Earnings – Jan	+0.5%	**+0.4%**		+0.6%
7:30 am	Average Weekly Hours - Jan	34.7	**34.7**		34.7