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I remember when my children were young, they were all so afraid of what was under their bed at night. They couldn't help but let their imaginations run wild, envisioning the worst possible things residing under their bed after dusk — horned and fanged monsters with an appetite for little children, and the occasional garden-variety mass murderer. In the morning, when they got the courage to look under the bed, they would always realize that their fears were worse than the reality of a few dirty socks. And so it is with investors imagining the worst possible scenarios for Federal Reserve (Fed) tightening this year. I suspect reality will be considerably better than their worst fears.

It's been breathtaking to watch the dramatic change in expectations surrounding the Fed this year. Estimates for rate hikes are all over the place, but they've been trending a lot higher in the past couple of weeks — and we've seen stocks and other risk assets fall in response. There are whispers that the Fed will end asset purchases at this week's meeting; others think the Fed could start to raise rates at this week's meeting. And some are anticipating as many as eight rate hikes this year — that may be worse than the giant eight-legged hairy spider under the bed that wanted to kidnap my daughter and bring her back to its human-sized web.

Let's face it — there's so much anxiety about whether the Fed will be forced into getting aggressive because of the level of inflation, and in doing so make a policy error. But from my perspective, markets are overestimating just how much the Fed will tighten this year.

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## Signs of 'normal' ahead

The Fed has three tools it plans to utilize this year to help combat inflation — tapering its asset purchases, raising rates, and reducing the size of its balance sheet. Given the range of tools at its disposal, I feel strongly that there is less pressure on the Fed to rely on its traditional tool — hiking rates — in a dramatic way. That doesn't mean it won't try to act quickly; however, acting early doesn't necessarily mean acting often. In other words, inflationary pressures may impact timing, but as we have learned from past rate hike cycles, it's not when the Fed begins but where it ends that will have a bigger impact on assets.

It's understandably unnerving for investors at the start of the tightening season to ponder what could happen this year. I think it's important to step back and see the bigger picture. In my view, much of what we have seen in recent weeks, some of which is causing unease for investors, signifies that we are on the path to "normal" for the global economy and markets:

- 1. We've seen a real and significant global stock market sell-off.** For the last 22 months, we've seen just a few stock sell-offs, mostly shallow, followed by rapid recoveries as market participants quickly piled back into stocks. The behavior we've seen over the last few weeks is reminiscent of a more normal market environment, punctuated by a very significant sell-off without an immediate recovery.
- 2. "Stay-at-home" stocks have been tanking.** Yes, Omicron is still raging in parts of the world, but in other parts it has already peaked. Stocks are clearly discounting a return to something more like a pre-pandemic world with people back to normal routines of gym visits and more entertainment outside the home.

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- 3. Supply and demand conditions are normalizing.** We're starting to see pent-up demand being burned off and supply improving. For example, the Empire Manufacturing Survey for January revealed a drop in new orders, a drop in unfilled orders and a drop in delivery times.<sup>1</sup> In addition, inventories rose. It was recently reported that both China and Vietnam are asking workers not to travel for the Lunar New Year in order to help reduce the spread of COVID-19 and therefore try to prevent labor shortages that can exacerbate supply chain issues.<sup>2</sup> This should help ease inflationary pressures.
- 4. We expect economic growth to improve in China.** Fiscal and monetary stimulus should help boost Chinese growth, moving closer to trend, in our view. Corporate earnings appear on track for a good year: Consensus expectations are calling for earnings per share growth of 13% for China for 2022.<sup>3</sup>

So let's not fear higher rates — we're seeing multiple signs of normalization that suggest we are getting closer to pre-pandemic conditions.

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### Speed bumps to watch for

Having said that, we are also seeing some speed bumps on the path to normal:

- Parts of the world are experiencing a big surge in COVID. COVID-19 is still spreading rapidly in parts of the world. And this spread is impacting economic growth, as evidenced in recent flash Purchasing Managers Index readings for the eurozone, Japan and the US.<sup>4</sup> We also have to recognize that the spread of the Omicron variant is likely to increase supply chain disruptions, so that should slightly delay the return to normal for prices.
- There are fears that Ukraine could be invaded by Russia as early as this week. The ensuing sanctions against Russia could drive up the price of oil, which in turn could add to inflationary pressures in the short run.

So we won't get back to normal tomorrow. And there are some aspects of the current situation that will be more persistent — such as labor market constraints and wage growth. We've been reminded of that in earnings results for the fourth quarter: As of Jan. 14, 60% of S&P 500 Index companies noted the negative impact of labor costs in their earnings calls.<sup>5</sup>

This inflation picture is what has market participants so worried about what the Fed might do; the monster under the bed gets bigger and uglier every day we continue to see elevated inflation and more sources of inflationary pressure.

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### What to watch this week

Looking ahead, I will be following these data releases particularly closely:

- US PCE Price Index. We always want to pay attention to the Fed's preferred measure of inflation, although I don't expect any surprises
- University of Michigan inflation expectations. This will be an important indicator of whether longer-term consumer inflation expectations remain relatively anchored, a metric that is important to the Fed

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And of course, we have some central bank meetings this week, including the Bank of Canada. However, all eyes will be on the Fed. I think Fed Chair Jay Powell will try to “thread the needle” in his press conference, talking tough but providing enough clarity and calm to shine a light on the monster under the bed, and perhaps dispel the worst fears of market participants. However, I don’t believe volatility or sell-offs will end with Powell’s words; I expect them to continue until at least the first rate hike.

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#### Notes

<sup>1</sup>Federal Reserve Bank of New York. The Empire State Manufacturing Survey is produced each month by the Federal Reserve Bank of New York to gauge manufacturing activity in the state of New York.

<sup>2</sup>Nikkei Asia, “China, Vietnam urge workers to hunker down over Lunar New Year,” Jan. 24, 2022

<sup>3</sup>Bloomberg, L.P., as of Jan. 24, 2022

<sup>4</sup>IHS Markit, Jan. 24, 2022. Purchasing Managers Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

<sup>5</sup>FactSet Earnings Insights, Jan. 14, 2022

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#### Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual US household expenditures.

The University of Michigan’s inflation expectations are published monthly, based on a telephone survey (the Surveys of Consumers) designed to assess US consumer expectations for the economy and their personal spending.

The opinions referenced above are those of the author as of Jan. 24, 2022. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.