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I'm so old that I can remember "pre-QE" fixed income markets — the time before quantitative easing when yields were more normal. As newlyweds back in 1996, my husband and I decided to buy a starter home. We met with a lending officer from a local bank (which has long since been acquired by a series of larger banks) who provided us with a plastic mortgage "calculator" — essentially a sliding scale that showed what your mortgage payment would be for every \$1,000 you borrowed, depending upon your interest rate. The calculator's scale ran from 6% to 20%, reflecting the range of mortgage rates for the last several decades. While I kept that gadget for posterity, it proved obsolete once monetary policy got very accommodative and mortgage rates fell well below 6%. Of course, just like A-line dresses and bell bottoms tucked away in the backs of closets, I suspect this relic in the back of my desk drawer might be useful once again, at least for my children.

# Markets struggle to adjust in the face of Fed uncertainty

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## The impact of experimental monetary policy

In my opinion, US mortgage rates are just one example of how experimental monetary policy from major developed central banks created financial repression and re-shaped fixed income markets in much of the world. While many economists and market observers have pined away for a "return to normal" for more than a decade, it really never happened. Yes, the US Federal Reserve — which led the charge on very experimental, accommodative monetary policy in the wake of the Global Financial Crisis — began a tightening cycle back in 2015, but it was as slow as molasses and never got very far before reversing course. And so here we are again, with major Western central banks beginning another tightening process — and for some, a far more aggressive one.

It stands to reason that there is a high level of anxiety in markets. We've all become accustomed to a low yield world after being mired in it for so long. Change can be very difficult, especially when it's coupled with uncertainty about high inflation and confusion about Fed policy. And so the ugly month of April has continued into May, helped along by continued confusion from the Fed. Fed Chair Jay Powell started off sounding very hawkish, addressing the American consumer directly and emphatically declaring that "Inflation is much too high" at his press conference following the May Federal Open Market Committee meeting. (This reminded me of an obscure populist politician in NY whose slogan was "the rent is too damn high" and created a single-issue political party based on it). Powell boldly stated that the Fed has the tools to bring inflation down and that it will use those tools. He reiterated that the Fed is "highly attentive" to inflation risks.

However, in the question-and-answer portion of the press conference (which, of course, is the unscripted portion), Powell got somewhat more dovish. When asked about what he thought the neutral rate was, he answered 2% to 3%. In addition, he said that a 75 basis point rate hike was not a consideration at this point. And that created some confusion and volatility for both equities and fixed income.

## Uncertainty abounds for markets

Markets are clearly confused about what the Fed will do this year and just how aggressive it will get. That can be seen in the volatility in expectations for where the fed funds rate will be at the end of 2022, as seen in fed funds futures. And it is reflected in stock market volatility, with the VIX above 30.<sup>1</sup>

This uncertainty exists for other major central banks — will they be able to thread the needle and tamp down inflation without sending their economies into recession? I believe each central bank will have to be data dependent to have the best chance to achieve a soft landing.

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In particular, the energy and wider commodity shock is a much greater challenge for the Eurozone and United Kingdom than it is for the US. In the UK, Bank of England (BoE) Governor Andrew Bailey has more or less signaled a high risk of recession, almost signaling a limit to the extent of tightening. The BoE has thus gone from being the most hawkish of the large central banks to being much further behind in the pack. In the Eurozone, asset purchases are likely to be wound down, but balance sheet reduction seems unlikely. And though rate hikes seem increasingly likely to start after mid-year, the hikes are likely to be smaller and slower than in the US.

In conclusion, change is difficult – especially when it is accompanied by confusion and uncertainty. I think it's worth noting that, despite a lot of volatility last week, the S&P 500 Index was essentially flat.<sup>1</sup> One friend of mine, who is a high-net-worth financial advisor, told me she's not getting calls from clients asking to sell securities, but she is getting calls from clients asking to switch from monthly statements to quarterly statements so they can avoid seeing volatility – and therefore avoiding getting rattled. I think taking a historical perspective is helpful: Rates are likely to still be relatively low once tightening ends — I don't think we'll need to consult anything other than the very low end of my old plastic mortgage calculator anytime soon. And while I don't expect this period of volatility and sell-offs to end immediately, as it's likely to take more time for markets to digest a new monetary policy world, I'm confident markets will adjust to this change. For long-term investors, I believe this digestion period can present buying opportunities in equities, fixed income and alternatives.

*With contributions from Arnab Das and Paul Jackson*

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#### Notes

<sup>1</sup>Bloomberg, L.P., as of May 9, 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.

Quantitative easing (QE) is a monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective. Quantitative tightening (QT) is a monetary policy used by central banks to normalize balance sheets.

The neutral rate is the theoretical federal funds rate at which the stance of Federal Reserve monetary policy is neither accommodative nor restrictive.

A basis point is one hundredth of a percentage point.

The Federal Open Market Committee (FOMC) is a committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

Fed funds futures are financial contracts that represent the market's opinion of where the federal funds rate will be at a specified point in the future. The federal funds rate is the rate at which banks lend balances to each other overnight.

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

The opinions referenced above are those of the author as of May 9, 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.