



**Kristina Hooper**  
Chief Global Market Strategist

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Last week, I was on the road four out of five days. It was helpful to be out and speaking with clients and other investors, both institutional and retail. Understandably, there is an enormous amount of negative sentiment and concern out there, so let's make sense of what's happening — starting with the Federal Reserve and its much-anticipated meeting this week, when it is widely expected to begin raising rates.

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## Weekly Market Compass | March 15, 2022

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### The Fed tries to balance short-term and longer-term concerns

The Fed has taken observers on a roller coaster ride in recent months in terms of expectations. At December's Federal Open Market Committee (FOMC) meeting press conference, we got a sense of how the Fed had pivoted more hawkishly — and that was crystallized once the December FOMC minutes were released in early January. And then the Fed pivoted again, more softly, with Russia's invasion of Ukraine. In the last month, expectations for rates (represented by fed funds futures) have shifted significantly, both in the shorter-term and in the longer-term — but differently.

A month ago, fed funds futures indicated there was a nearly 50% probability of a 50 basis point rate hike in March.<sup>1</sup> Now there appears to be 0% probability of a 50 basis point rate hike — and a nearly 5% probability of no rate hike at all.<sup>1</sup> How can that be after the Consumer Price Index print last week, which showed 7.9% inflation?<sup>2</sup> Well, let's put it this way: There are no Paul Volckers in this Fed. In the early 1980s, Volcker famously raised the federal funds rate from 11% to a peak of 20% in an effort to combat inflation.<sup>3</sup> Today, FOMC participants are unwilling to take dramatic action — and with good reason; there are some inflationary pressures the Fed can't solve for.

While expectations for the March FOMC meeting have turned more dovish than had been expected a month ago, expectations of where the fed funds rate will be by December have turned more hawkish than expected a month ago. The probability of 125 basis points in rate hikes by December have increased from 29.3% to 34.6%.<sup>4</sup> The probability of 150 basis points in rate hikes have also increased — from 16.4% to 21.3%.<sup>4</sup>

These shifts reflect competing concerns — worries about the impact on economic growth and financial stability in the very near term and worries about the impact on inflation in the coming months. The delicate engineering of a soft landing has gotten that much harder for the Fed. However, I continue to believe that the Fed will be more data-dependent than they would have been prior to Russia's invasion of Ukraine, which increases the potential that it will be able to navigate a soft landing for the US economy.

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### Longer-term inflation expectations remain relatively well-anchored

One factor that the Fed will look to in determining how aggressive it is in tightening is inflation expectations. The Fed wants to ensure that inflation expectations for the longer term remain relatively well-anchored, and so that data will be an important consideration. The most recent data from the New York Fed's Survey of Consumer Expectations indicated that inflation expectations for the one- and

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three-year periods had peaked and were starting to moderate. However, those results were compiled before Russia invaded Ukraine.

Last week's Survey of Consumers from the University of Michigan gave us our first hint into how the crisis in Ukraine and the ensuing spike in commodities prices is impacting inflation expectations. Not surprisingly, it has had a substantial impact on inflation expectations in the shorter term, causing the one-year ahead expectations to move significantly higher in March. The good news is that inflation expectations for three years ahead have not changed, suggesting they continue to be somewhat well-anchored. And it's the longer-term expectations that the Fed will pay much closer attention to, and so we will want to pay close attention to that figure.

We believe it's also important to keep an eye on financial market-based indicators of inflation expectations. So far, the relationship between Treasuries and inflation-protected Treasuries indicate an expectation for higher inflation in the nearer term that moves lower in the longer term, although expectations for all time frames are elevated. On balance, we believe the markets and the public still believe the Fed will do what's necessary to rein inflation, which probably means that it won't have to do as much as it would if its credibility and reputation were to slip.

Consumer and corporate inflation expectations likely matter more to the Fed, ultimately, than financial market expectations, because they could cause a self-fulfilling rise in inflation as rising expectations generate increases. But market expectations are likely to move more rapidly in response to shocks in energy, food grain, and other commodity markets as a result of the Russo-Ukrainian War, and hence may serve as a leading indicator of whether the Fed will need to hike faster or further than now expected and priced-in. The Volcker Fed, after all, felt it had to hike even more significantly when it saw that the bond market was not convinced of its complete intent to control inflation after its early rate hikes.

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### **The European Central Bank surprised markets**

Inflation concerns are certainly on the minds of the policymakers at the European Central Bank (ECB) as well. The ECB surprised markets last week by speeding up the tapering of its balance sheet purchases. This was more hawkish than most expected, but it should not have been surprising given the ECB only has one mandate (stable prices) rather than the Fed's dual mandate (stable prices and maximum sustainable employment). I believe that is what forced the ECB's hand to be more hawkish than expected, but I don't believe we will see the same from the Fed in the coming week.

The Russo-Ukrainian War makes threading the needle harder for the ECB, and secondly the Bank of England (BOE), than for other major central banks not only because Europe is at the frontline of the hostilities, but also because it's at greater risk of stagflation than the US or China. Unlike the US, Europe depends heavily on energy imports from Russia as well as food grains from Ukraine, and supply is threatened by both hostilities and sanctions – especially if there is an

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embargo by either Russia or the West. So far, there is a major price shock, but no real evidence of an interruption in supply – if anything, Russia is piping more gas into Western Europe than it was before the war. But if there were an actual, sizeable supply shock, Europe would face both higher inflation and a more severe growth slowdown.

Another element of eurozone (EZ) uncertainty is the labor market. US and UK labor markets are more flexible than in the EZ, so both wages and employment move more quickly. Hence we are seeing a faster feed-through from inflation to wages amid low unemployment in the US and UK, than in the EZ. But EZ wages, especially in the largest economies such as Germany, are set by collective bargaining – and those wage negotiations are only just getting underway.

We believe this uncertainty means that there could be significantly higher inflation in the EZ and lower growth to come – and therefore that the ECB may continue to normalize policy, but be more cautious and even more data-dependent than the Fed. The BOE, however, seems more likely to be closer to the Fed because it already has a higher inflation problem with less unemployment and a similar energy price problem as the EZ.

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### **COVID-19 spreads across China**

With all eyes on the FOMC, we might overlook other important developments. One is the rising number of COVID-19 cases in parts of the world. There are a number of countries, such as China, that were able to avoid the high level of COVID-19 infections much of the world experienced in the last two years by instituting higher levels of stringency. However, that is not working against the far more contagious but less dangerous Omicron variant.

Last Saturday, China's National Health Commission announced that another 1,524 locally transmitted coronavirus cases had been detected in provinces across mainland China. That is a substantial increase over just several hundred cases per day a week ago.<sup>5</sup> More cities are being locked down, including Shenzhen – a major manufacturing hub. Brace yourselves, as I expect this should temporarily add to supply chain disruptions and inflationary pressures and negatively impact China's economic growth. However, this does not change my positive outlook on China. Ultimately, Omicron has proven to be a rapid immunizer of large populations, enabling them to reopen more robustly once the wave ended. I still anticipate the back half of 2022 into 2023 to see a re-acceleration in growth in China, which should be supported by more supportive fiscal and monetary policies.

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### **Conclusion**

In conclusion, there are a number of headwinds facing economies and markets right now which should mean a continuation of heightened volatility. But in my view, none should be a deterrent for investors with a longer-term investing horizon. Conversely, volatility can present attractive buying opportunities for select risk assets. Indeed, in previous monetary policy tightening cycles, we have seen

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certain risk assets rise and economic growth continue.<sup>6</sup> If monetary policymakers execute a soft landing wherein inflation is contained and the economic expansion continues, we may see that this cycle has longer to run yet.

*With contributions from Arnab Das and Ashley Oerth*

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#### Notes

<sup>1</sup>CME Group, March 11, 2022

<sup>2</sup>US Bureau of Labor Statistics

<sup>3</sup>Associated Press, Ex-Fed Chair Volcker dies, tamed inflation with recession," Dec. 9, 2019

<sup>4</sup>CME Group, March 11, 2022)

<sup>5</sup>The New York Times, "Covid News: China Dismisses 2 Mayors and Shanghai Closes Schools as Case Numbers Rise," March 11, 2022

<sup>6</sup>For example, the S&P 500 Index went up in six out of six Fed tightening cycles since 1983, according to Invesco analysis of Bloomberg L.P. data. The six Fed tightening cycles from first to last hike were 1983-1984, 1987-1989, 1994-1995, 1999-2000, 2004-2006, and 2015-2018.

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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.

Past performance is not a guarantee of future results.

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

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.

Treasury Inflation-Protected Securities, or TIPS, are a type of US Treasury security whose principal value is indexed to the rate of inflation. When inflation rises, the TIPS' principal value is adjusted up. If there's deflation, then the principal value is adjusted lower.

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics. Core CPI excludes food and energy prices.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan designed to assess US consumer expectations for the economy and their personal spending.

The New York Fed's Survey of Consumer Expectations contains information about how consumers expect overall inflation and prices for food, gas, housing, and education to behave. It also provides insight into Americans' views about job prospects and earnings growth and their expectations about future spending and access to credit.

Risk assets are generally described as any financial security or instrument that carries risk and is likely to fluctuate in price.

Quantitative tightening is a monetary policy used by central banks to normalize balance sheets.

A basis point is one hundredth of a percentage point.

The opinions referenced above are those of the author as of March 14, 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.