

Markets balk as the Fed signals a faster rate hike timeline

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Last week was a difficult one for markets. The Federal Reserve seems to have rattled investors by mentioning the prospect of tapering its bond purchases and by adding two potential rate hikes to its forecast for 2023. So I wanted to share some thoughts on what's going on and what I expect to occur next.

A rough week for markets

Media headlines keep screaming that this was the worst week for the stock market since last October. But let's put this in perspective: there have been no significant sell-offs for the US stock market in nearly a year. And so yes, it was the worst week for the Dow Jones Industrial Average since October, and the VIX did rise significantly, but the Dow only fell 3.45% last week.¹ And the S&P 500 Index only fell 1.91%.¹ In other words, the US stock market sell-off may have constituted the biggest sell-off of the year, but it was very tame. And the sell-off in global stocks was even more muted.

It wasn't just stocks. The 10-year US Treasury yield took a bit of a rollercoaster ride last week because of the Fed. It initially got close to 1.6% on Wednesday,¹ anticipating higher rates because of the Fed's announcement and subsequent statements. However, then the yield moved lower, with additional downward pressure created by St. Louis Fed President James Bullard's comments on Friday. He shared that he could see a rate hike occurring as early as late 2022.² This sent the yield on the 10-year Treasury below 1.44% on Friday afternoon.¹ It seems investors bought up Treasuries and pushed yields lower as they began anticipating a slower economic recovery because the Fed expects to tighten.

The 'dot plot' unnerved investors, but it's not set in stone

We shouldn't be surprised that the Fed is having such an impact on markets. The Fed has played an outsized role in the stock market since it began providing extraordinary monetary policy accommodation in the global financial crisis. The central bank of the United States has taken on a far more proactive role than it had before 2008, and so moving markets is just part of the deal of having such an activist central bank.

The Fed has increasingly focused on over-communicating with the public since the pandemic began. However, no communication can be flawless or without incident, especially when it's about monetary policy tightening. What seemed to unnerve investors last week was not tapering — which had been well-communicated in advance — but the change in the dot plot for the fed funds rate (and then the suggestion that the first rate hike might occur even sooner). But while markets were surprised and dismayed to see expectations of two rate hikes in 2023 and the possibility of a rate hike in late 2022, frankly, I was surprised by the market's surprise. Obviously, the expected timeline for rate hikes is likely to move up given the strength of this recovery, which is far more robust than the recovery following the global financial crisis.

And it's important to remember that the dot plot is merely each individual Federal Open Market Committee member's policy prescription — not a binding contract nor a plan set in stone. If there is anything we have learned from the Fed, it is that in recent years it has become more holistic in its assessment of when monetary policy action is appropriate. The hard targets have softened and become more nuanced. The Fed will likely not tighten in 2023 if the economy is weaker, and it may tighten as soon as 2022 if conditions warrant.

What next?

Monday has seen a partial recovery for US and European equities as of this writing, which is a positive development and indicates the resilience of the stock market. However, global stocks could certainly experience a significant drop this summer. This is a precarious time — stocks have gone a relatively long period without any major sell-off, and there is heightened sensitivity to every utterance from the Fed as it attempts to transition to the start of normalization. But isn't that what many investors have been looking for? There has been little opportunity for attractive entry points since last year; this could be that opportunity if there is a hefty sell-off. Whether or not investors take advantage of tactical opportunities, I believe it's important to stay the course for the long haul — to be well diversified across asset classes but maintain adequate exposure to a broad array of equities.

Source

¹Source: Bloomberg, L.P. Past performance is not a guarantee of future results. An investment cannot be made into an index.

²Source: CNBC, "Fed's Jim Bullard sees first interest rate hike coming as soon as 2022," June 18, 2021

Important information

Diversification does not guarantee a profit or eliminate the risk of loss.

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.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

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.

The Dow Jones Industrial Average is a price-weighted index of the 30 largest, most widely held stocks traded on the New York Stock Exchange.

The federal funds rate is the rate at which banks lend balances to each other overnight.

The opinions referenced above are those of the author as of June 21, 2021. 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.