

HOUSE VIEW

2022

THE FED AND THE PURSUIT OF THE LAGRANGE POINT

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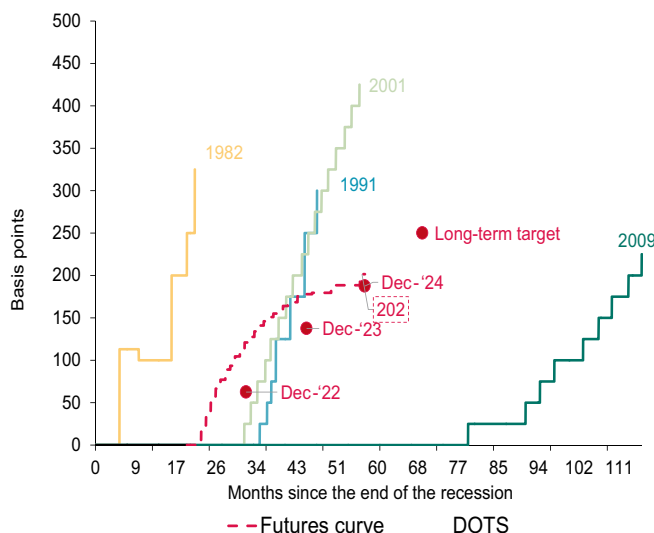
As the Fed held its penultimate meeting, mankind was taking yet another giant leap in the conquest of space, launching the James Webb, the largest, most complex space telescope ever built. Its destination: the second Lagrange point. A point of gravitational balance in the Sun-Earth-Moon system where a spacecraft can harness the forces of motion between the bodies to save energy and extend its useful life.

Following the colossal liquidity injection implemented over the two years of Covid (the four largest central banks alone have pumped \$12.8 trillion into the system, 3.6 times more than in the last recession) and with inflation at 7%, now is the time to start tapering. So isn't this the "exceptional balance point" that monetary authorities are seeking - with the Fed at the helm - to stretch the economic cycle?

The authorities have poured a great deal of fuel into the system, and now that the pandemic is tentatively contained and the global economy is heading into a more normalised growth phase (it will grow by 4.2% in 2022, three tenths of a point higher than the historical average), it is time to start tapering.

1. FED: OFFICIAL RATE HIKE PROCESS

Sources: Bloomberg and Banca March



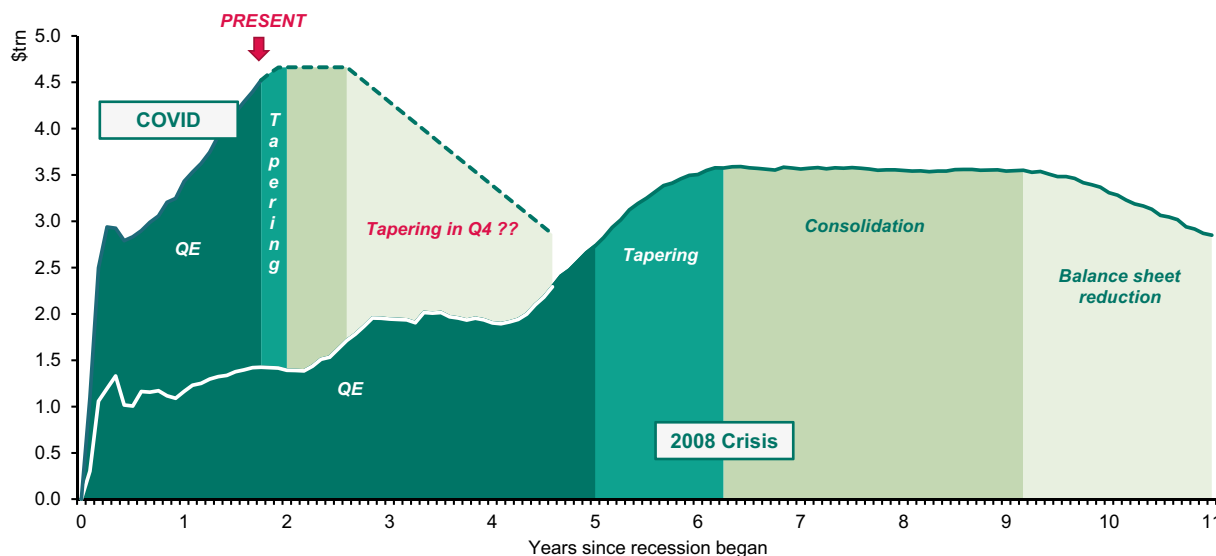
This process, which will begin with the most hotly-awaited rate hikes of the last 40 years, must be approached with the utmost sensitivity and skill. A far more precipitous movement than in the previous cycle, when rate hikes began 7 years after the crisis. At Banca March, we expect to see four hikes in 2022 and another 3 next year. What's more, this time the rate hikes will be accompanied by a tapering of balance sheets in the final quarter of the year, whereas in the last cycle, a year and a half went by between the first rate hike and the tapering announcement.

At that time, 4 years after announcing it would begin tapering, the Fed shrunk its balance sheet by 19% over the course of 24 months. If this pattern were repeated now, it would mean shaving \$1.7 trillion off the balance sheet over 2 years, equivalent to \$70 billion per month. Depending on the intensity of the recovery and how inflation evolves, this amount would also have to account for the \$1.14 trillion in Treasury bonds set to mature over the next 12 months; on average, \$95 billion a month.

The monetary authority will also need to carefully and accurately gauge the market's capacity to absorb mortgage-backed securities. It currently holds \$2.6 trillion on its balance sheet, of which \$575 billion was bought in 2021 (67% of net issuances).

2. ACCUMULATED EXPANSION FED BALANCE SHEETS

Sources: Bloomberg and Banca March



We are heading into a period which is anything but a point of balance: a period in which the markets will be constantly questioning the extent to which central banks have the situation under control. The Fed has already implied that it will begin the process of raising rates on 16 March; not only will that time coincide with 40-year highs in US inflation, but there will also quite possibly be no evidence yet that a turning point has been reached, as we expect inflation to top out shortly afterwards in early Q2, thanks to the base effect of raw materials.

By then, the James Webb will 1.5 million kilometres from the Earth, ready to transmit the first images of the origins of the universe, seeking to achieve the seemingly impossible: to orbit the Lagrange point to avoid the Earth's shadow whilst saving energy.

Achieving a perfect balance, like the James Webb, is not easy. Especially when liquid assets are pricing in an infinity of scenarios every day. The market backdrop is good, but it important to bear in mind that the scenario is not the same as the last two years, as tapering measures will always bring increased volatility. Meanwhile, we weather the turbulence ahead with patience.

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