Mizuho Insights: Fed & EM (Asia)

MIZUHO

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What to Make of Hawkish Fed Pivot?

In a nutshell: Having been **blindsided by** successive multi-decade **inflation highs in 2021**, the **Fed has turned increasingly and emphatically more hawkish**. Hastening *QE wind down by*, with a *tight transition to rate lift-off* as early as, **March 2022** aside, the prospect of **quantitative tightening (QT)** "*relatively soon*" is **arguably the biggest hawkish jolt**. But this pursuit of policy catch-up, assumes the **risk of blurring the distinction between speed and haste**. *Especially as* **unprecedented compression of transitions between taper-to-hike and hike-to-QT** colliding with **aggressive step-up in the pace of** "*sooner and faster*" **tightening** (taper, hikes as well as QT) heightens risks of unintended policy over-steer. Put another way, such a ***hawkish pivot accentuates the odds of a policy mistake***.

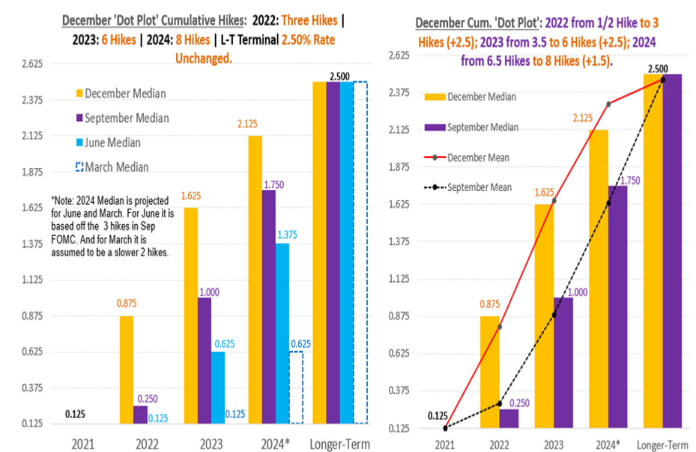
Arguably, **assessment of policy mistakes is slippery**, being e***x-post comparisons to the counter-factual*** (e.g. "Had we not, the outcomes would be worse"). What's relatable though is **realized economic/financial market pain and turbulence** from *tighter liquidity, rising interest rates/yields*, subsequent asset market pressures (risk re-pricing) and, a *stronger USD* resulting from a hawkish Fed. This ***combination of liquidity, rates, risk premium*** and ***exchange rate dynamics*** *typically hurt EM (Asia) the most.*

Sooner & Faster

Having been caught wrong-footed by cost-push, initially discounted as "transitory", but later assessed as potentially stickier inflation at four-decade high, the **instinct for compensatory hawkish policy shift is understandable**. Resultant **hardening resolve to get ahead of the curve on inflation risks** is being **distilled down to** "*sooner and … faster*" **tightening**.

Taper: Both the ***timing*** and ***pace* of taper have been hastened substantially**. Taper **initiated Nov 2021** and set to ***wind down rapidly by Mar 2022*** **significantly front-runs and outpaces early-2021 expectations** for taper to start late-2022 and phased out far more gradually.

Rate Hikes: "*Sooner and … faster*" **rate hikes** gain prominence as 'Dot Plot' for Dec FOMC hardened to ***three rate hikes for 2022*** (and another three for 2023), sharply higher from Sep 'Dot Plot' of none in 2022 (and three in 2023). What's more, this now is being **bumped up to market expectations of four hikes in 2022 with *rate lift off starting as early as March***.



Quantitative Tightening (QT): Crucially, Dec FOMC Minutes flag up prominent prospects for **quantitative tightening (QT) to follow** *"relatively soon after beginning to raise … rates"*; widely perceived to be late-2022/early-2023. This is **significantly sooner than the earlier impressions** of QT being a slightly more distant prospect in sequenced policy exit.

QT the Biggest Hawkish Jolt?

Unlike taper that merely tempers accommodation rather than tightening outright, **QT** is **tightening at the sharpest**. Not only are ***both front-end funding costs and longer-end yields tightened***, but ***risk/credit premium is also lifted*** (via retrenchment of MBS). And *in simultaneously lifting risk-free rate, term premium* and *risk/credit premium, tightening in financial conditions is accentuated.*

Which is why **QT being fired up far earlier than expected** may be the **biggest Hawkish jolt for markets** may be from.

Proximate & Profound

What's more, **exceptionally compressed transition from taper-to-hikes-to-QT *may render tightening disproportionally more profound***. That is, an acutely compressed **transition** *(Nov 2021 to late-2022/early-2023) from taper-to-hikes-to-QT,* as brief as **12-17 months**, is likely to **amplify** the stand-alone effects from various elements (taper, rate hikes, QT) of the **Fed's re-tightening**. For perspective, the *last tightening cycle, transition from taper to QT rollout* spanned **46 months** (Jan 2014 to Oct 2017); 3-4 times more spaced out.

Policy Tool	2014-19 Tightening	2021-24 Tightening
Taper	Jan '14 to Oct '14	Nov '21 to Mar '22 (?)
Rate Hikes	Oct '15 to Dec '18	Mar '22(?) to ???
QT	Oct '17 to Jul '19	Oct'22-Mar'23 to ???
Transition	**Transition Timeline**	**Transition Timeline**
Start Taper to Rate Lift-Off	24 Months (Jan '14 to Dec '15)	5 Months? (Nov '21 to Mar '22)
End Taper to Rate Lift-Off	14 Months (Oct '14 to Dec '15)	0 Months? (Mar '22 to Mar '22)
Rate Lift-Off to QT	22 Months (Dec '15 to Oct '17)	7-12 Months? (Mar '22 to Oct '22-Mar '23)

End-Taper to Rate Hike Initiation (Lift-Off): Moreover, there was a **distinct one-year gap between the end of taper and rate lift-off in the last cycle**. *In sharp contrast,* the Fed appears to suggest, and certainly appears open to, overlapping lift-off and taper in March. That's to say, *no "cooling off" period between QE wind down and rate lift-off this time.*

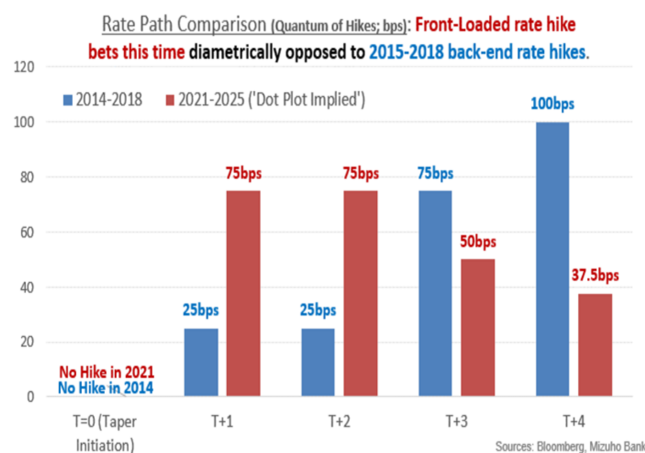
Lift-Off to QT initiation: What's more, **between rate lift off** (Dec 2015) **to QT** (Oct 2017) kick off, there was **a 2-year wait in the last cycle**. *Whereas this time, "patience" on QT may be whittled down to just a mere 5-12 months;* with QT initiation tilted to late-2022.

Upshot being, the unprecedented **proximity between taper, hikes and QT**, a significant departure from past experience, **warns of far more profound tightening effects** than may be inferred from the previous experience. Especially ***should there be "resonance" of the various tightening measures****;* true to the adage of the *whole being greater than the sum of its parts*

"Kokomo" Fed

This **confluence of** "*sooner and faster*" rate hike path alongside **compressed taper-hike-QT transition square with our view of a 'Kokomo Fed'***.

That is, the Fed *cranking up the hawkish dial early in the game to hasten tightening,* but *so that it may avert having to overcompensate* (for being behind the curve) later. Admittedly, at this juncture, the "*get there fast*" may be more evident that the "*and then … take it slow*". But the intent is implied given the unchanged longer term 2.50% terminal rate of the 'Dot Plot'.



Notably, **a front-loaded 'Kokomo'** approach is the **diametric opposite of the gradual, and cautious rate hike path in the last rate hike cycle** (2015-2018); in which the Fed gently calibrated rates 25bps higher each in 2015 and 2016, before stepping up to 75bps of hikes in 2017, and culminating in a 100bps in 2018, to end the hiking cycle.

Between Speed & Haste …

Regardless, the **glaring risk** of "*sooner and faster*", tightening **delivered in compressed taper-hike-QT transition** is that there may be **an inadvertent oversteer** (over-tightening); unfortunately, **before relief from** "*and then … take it slow*" embedded in the 'Kokomo' approach may be derived.

This **blurs the line between speed** necessary to arrest inflation expectations (and get ahead of the curve) **and haste** that may compromise the recovery.

… Policy Mistakes Lurk

Inevitably, this **urgency to get "ahead of the curve"**, by resorting to engaging all the tools "sooner and faster" with compressed transitions, **dials up the odds of a policy mistake**.

But there are **two key nuances** about the potential for the Fed's policy mistakes.

First, a **policy mistake is hard to establish** given the counter-factual (and the argument that the alternative

would have yielded worse outcomes) cannot be definitively assessed to be superior. ***Whereas the impact/pain from policy moves may be assessed.***

Second, **EMs are liable to pay a heavier price for a Fed policy mistake** (of over-tightening).

EM at the Sharp End …

These two nuances dove-tail in a world where *sharply higher rates, pronounced increase in risk premium* and *tighter global liquidity,* (reinforcing negative asset market dynamics) **conspire to hurt EM most acutely**.

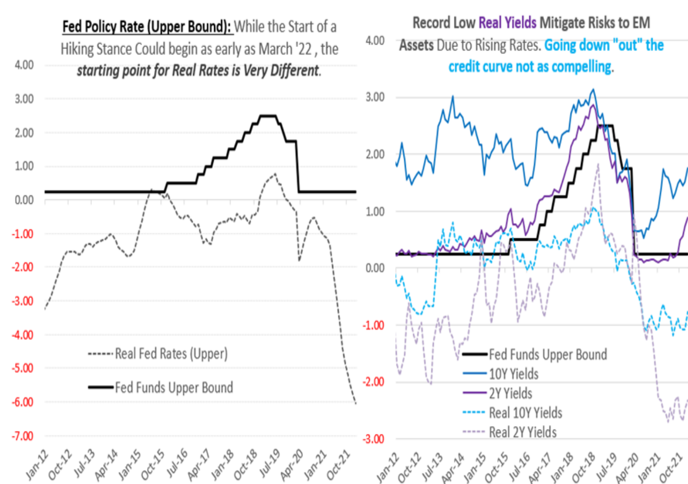
For one, ***rising long-end yields*** (comprising a pick up in the risk-free rate and term premium) would in and of itself **incite asset *reallocation away from "higher-risk" (EM) assets to longer duration safe assets***.

What's more, ***higher risk premium*** accentuated by ***tighter global liquidity*** (from QT) leaves ***EM assets vulnerable to even sharper sell-off; especially if a confidence-price spiral is triggered***.

The **upshot is that EM economies are at the sharp end of the Fed's hawkish pivot**; and the **uneven global recovery** whereby EMs are lagging **only adds insult to the (potential) injury**, and **sharpens the policy trade-off for EMs** even if they are inclined to follow the Fed's lead on tightening.

… Albeit with a Silver Lining

But it is **not all doom and gloom**.



In particular, the **silver lining** is that **high US inflation** means **real US rates/yields remain exceptionally low**. As a corollary, **real EM-US spreads** (difference between ***real*** EM and US returns) will not erode as sharply as nominal US rates/yields are rising.

What this means is that **despite sharply higher and rising nominal US rates/yields**, the corresponding real returns in EM will not deteriorate as sharply. And by virtue of this real return buffer offered by EM, **worse case capital flight from, and more adverse sell off in, EM may be blunted**.

Lining, Not Bullet

But while exceptionally low US real rates/yields are welcome **silver linings offering some degree of insulation**, they are **not to be mistaken for silver bullets that provide unfettered immunity**. Specifically, **high US inflation providing limited cover from the real rate/yield impact of** "*sooner faster*" **rate hikes** does not negate ***"live" risks*** of ***brutal global liquidity squeeze*** and the ***attendant step-up in "risk premium"*** from *"sooner and faster" Fed **balance sheet run-off (QT)***.

The Acute QT Factor

All said, **risks associated with the Fed's hawkish pivot**, appear to be **most acute around** the **timing and speed of QT**. Especially in the context of **uncertainty** (and attendant volatility) from "*sooner and faster*" **balance sheet run-off**; as the Fed's mind-boggling \$8.8trln balance sheet, bloating by a staggering ~\$4.6trln since Feb 2020 incites **unprecedented intensity of QT**. And there is *nothing "un-real^" about* **sharp swings** higher **in risk premium**.

5 EM Asia Take-aways

With QT spear-heading the Fed's hawkish pivot, there are **five key take-aways for EM Asia**:

1) EM Asia central banks will be confronted by sharper policy trade-off; as a hawkish Fed accentuates macro-stability risks.
2) As a result of which, a more complete EM Asia recovery may be deferred and dampened.
3) Volatility will dominate as tensions between exceptionally low real US rates and rising risk premiums obfuscate asset market reallocation.
4) Downside risks in EM Asia assets/currencies, while mitigated, will not be eliminated.
5) Tail risks of an acute correction in EM Asia assets/currencies resulting in real economic downturn, while not the base case, cannot be ruled out given elevated policy uncertainties.

* Please refer to Mizuho Insights – The Kokomo Conjecture, 8th Dec 2021 for a more detailed discussion.
^ as opposed to higher risk-free rates being tempered by high inflation, which renders "real" rates exceptionally low.

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