Nervous reaction on Wall Street to Fed minutes

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The high degree of sensitivity in financial markets to the prospect of a lift in interest rates was illustrated yesterday when Wall Street experienced a significant fall after the release of the Fed's minutes showing it was considering tightening monetary policy at a faster rate than previously anticipated.

The Fed signalled its intentions at its December 14–15 meeting when it decided to complete its purchases of financial assets by March. The meeting minutes provided further details of that decision, leading to a sell-off in the last two hours of trading upon their release.

The tech-heavy NASDAQ index dropped by 3.3 percent, its biggest decline since February 2021, the S&P 500 was down 1.9 percent, after reaching a record high earlier this week, and the Dow Jones, which had also set a record high, lost 392 points or 1.9 percent.

According to the minutes: "Some participants judged that a less accommodative stance of policy would likely be warranted and that the committee should convey a strong commitment to address elevated inflation pressures."

Another paragraph to attract attention was the following: "Participants generally noted that, given their individual outlooks for the economy, the labor market and inflation, it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated."

The reference to the labor market underscored remarks made by Fed chair Jerome Powell at his press conference of December 15. Announcing the decision to bring forward the ending of asset purchases to March, rather than June, he said: "There's a real risk now… that the risk of higher inflation becoming entrenched has increased. That's part of the reason behind our move today… to put ourselves in a position to be able to deal with that risk."

The "entrenching" of inflation refers to a situation where elevated price rises—headline inflation in the US is running well above 6 percent—lead to demands by workers for higher wages, which has already started to take place. Concerns have also been voiced in business circles about the re-introduction of cost-of-living adjustments in some wage contracts.

These issues were reflected in the minutes. They pointed to concerns that continuing supply chain problems and labor shortages meant rising prices were likely to continue and "last longer and be more widespread than initially thought."

The official commitment of the Fed is to keep interest rates at near zero until inflation averages 2 percent over time and maximum employment has been reached.

The minutes noted that the first condition had been "more than met" with "several" participants indicating that labor market conditions were "largely consistent" with the second target. Most participants believed they could "fast approach" that goal if present trends continued.

But with their eyes firmly fixed on wages and the labor market, some officials suggested that Fed could start raising interest rates before maximum employment had been achieved.

The general expectation has been that the first increase in rates would come some time after the March meeting when asset purchases cease.

But Fed governor Christopher Waller has suggested the first rise could come at the March meeting itself. "The whole point of accelerating the taper was… so the March meeting could be a live meeting. That was the intent," he said two days after the Fed meeting. By a "live" meeting he meant one at which the Fed could announce a rate rise.

Another significant feature of the meeting revealed by the minutes was the discussion on reducing the size of the Fed's asset holdings, which now stand at just under $9 trillion. It more than doubled following the March 2020 financial crisis at the start of the pandemic.

According to the minutes, some participants suggested a move to reduce the Fed's asset holdings could begin "relatively soon" after interest rates were increased. This is a sensitive issue for Wall Street because the Fed's asset holdings are a crucial prop for the speculative surge that has sent the share market to record highs as the pandemic has continued to surge.

The last time a reduction was discussed was in 2018 when Fed chair Powell indicated the Fed's asset holdings would be cut by $50 billion a month to normalise monetary policy and the reduction was on "auto-pilot." At that time, the asset holdings were around $4 trillion as a result of the quantitative easing program following the market crash of 2008.

This produced a furious market reaction whereupon the Fed beat a hasty retreat taking planned interest rate rises for 2019 off the table and scrapping the asset reduction plan.

There could well be a repeat of these events. In a note issued yesterday, cited by the *Wall Street Journal*, Chris Zaccarelli, chief investment officer at Independent Advisor Alliance, said the belief of his organisation was that the Fed was "likely to raise interest rates quicker and potentially shrinking their balance sheet sooner than many expect as they signal fighting inflation is more important than protecting against a drop in economic activity.

"What is harder to forecast," he continued, "is to what level of market selloff they are willing to tolerate before changing course."

The fear is that such is the addiction of Wall Street to low rates to finance its speculative binge that even a relatively small rise in rates and a minor tightening in monetary policy overall could precipitate a crisis.

These concerns were reflected in the Fed minutes with "several" participants pointing to "vulnerabilities," including in the US Treasury market that went into a meltdown in March 2020. This could limit how rapidly the Fed was able to reduce its balance sheet.

The fine line the Fed is treading—seeking to suppress wage demands while not setting off a market meltdown—was highlighted by a comment by financial analyst Mohamed El-Erian published in the *Financial Times* on Tuesday.

"The possibility of the Fed losing its nerve, as it had done repeatedly in recent years, would be viewed by markets as constructive in the short term," he wrote.

This is because it would keep the central banks "engaged in offsetting hits to asset prices," in particular equities. He questioned the durability of any interest hiking cycle because "a system conditioned by more than a decade of floored interest rates and ample liquidity would quickly prove unable to tolerate higher rates."

"Tighter financial conditions, while warranted by persistent inflation, would foster a highly unfriendly combination of financial instability and lower private demand," he wrote.

This would lead in its extreme to "stagflation"—including a "sharp drop in economic activity"—and policies that become "a lot less effective at a time just when markets are dealing with the trifecta of hitherto-underpriced liquidity, credit and solvency risk."

The nervousness on Wall Street in response to the Fed minutes is a warning sign of the underlying instability of the entire financial system.