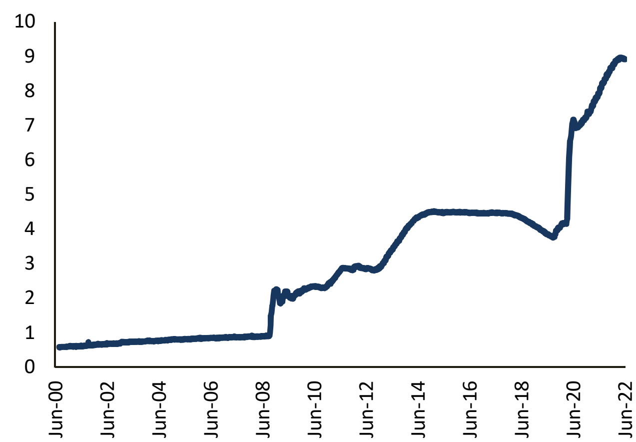
Fed in a Tight Spot

Federal Reserve in its last meeting decided to raise rates and maintained its hawkish stance. Powell signalled that the Fed's policymaking committee expected to implement 0.5% increases at its next two meetings, but was not "actively considering" a more aggressive 0.75% increase. The annual pace of consumer price inflation in the US hit 8.6% in May as energy and food costs surged. US Treasuries have jumped since the start of April and is above 3% mark ahead of the FOMC meeting scheduled this week. Most expect that Fed rates could reach upto 3% by next February. In the recent times, treasuries have been under pressure as the Fed began its long drawn process of quantitative tightening, reducing its balance sheet by allowing bonds that it bought to mature without replacing them. Be it the Fed meeting, US President's and Treasury secretary testimony or be it the meeting between US President and fed Chairman everywhere the commentary has been that "Inflation is a concern and we need to do more to ease ongoing price rise".

Quantitative Tightening(QT) on the go

Markets have been volatile in recent weeks as investors grappled with conflicting signs about the health of the global economy and predictions about the future paths of inflation and interest rates. Most riskier assets across the globe have been under pressure as liquidity tightening has been on the go for most central banks. With inflation resurgent and anything but transitory, as the easy money crowd has long been arguing, the Fed cannot easily back off to reassure investors, as it has for over three decades. Officials in the US are becoming increasingly concerned that shifting to neutral will not be enough. The Fed may have to slam on the brakes and also raise borrowing costs beyond 3%. Since the start of the year most investors realized that inflation was for real and yields rose across the curve.

US Fed Balance Sheet (Tln $)



Source: Reuters

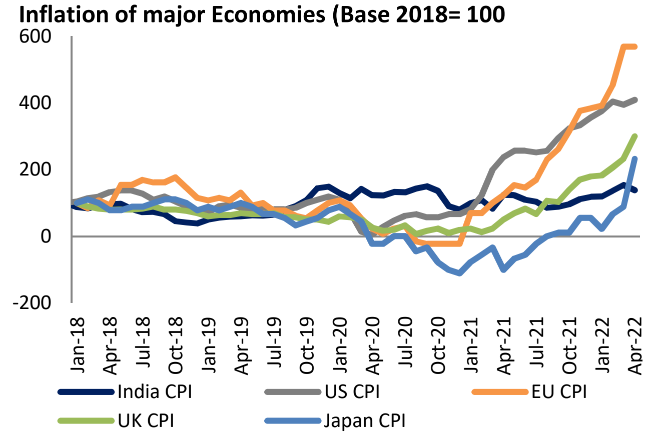
During the last FOMC meeting, several officials also pointed to some risks to financial stability related to the tightening cycle, saying it could "interact with vulnerabilities related to the liquidity of markets for Treasury securities and to the private sector's intermediation capacity". In addition to monetary tightening, this month the Fed began shrinking its $9tn balance sheet, which may amount over time to the equivalent of two or three rate rises. There are two reasons why investors and policymakers are watching QT closely. The first is its potentially vast impact on monetary policy. The second being that QT will cause the treasury market to malfunction.

Inflation a bigger concern

Inflation is on the rise for most of the nation globally and rise in energy prices has been one of the major contributors. Russia's invasion of Ukraine pushing up energy and food prices and squeezing households' real incomes. Latest figures for most of the world's largest economies make for worrying reading, with price pressures surging to the highest level in many decades.

The key debate among policymakers and economists remains focused on how long high inflation will last. A few months ago, many expected the surge to be too short lived for monetary policy to have much of an impact, with the effect of higher rates taking time to seep through into economies. However, the conflict in Ukraine — along with signs that inflationary pressures have become more broad based — have exacerbated fears that inflation will prove stickier than hoped. Markets' expectations for inflation over the next five years are generally rising, suggesting support for the view that the pain businesses and households are experiencing will endure.

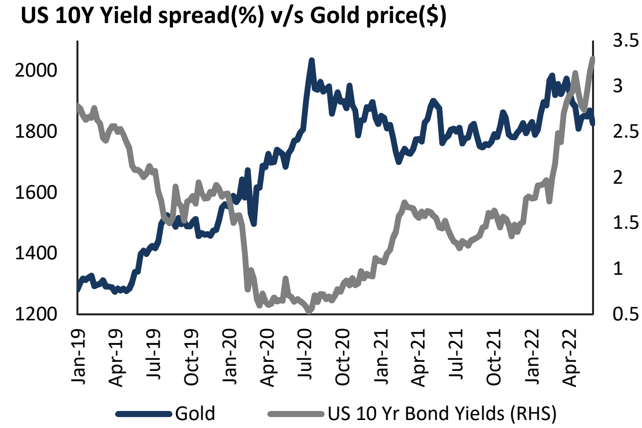
Inflation of major Economies (Base 2018= 100



Source: Reuters

On Comex, gold and silver has seen an increased volatility and currently we are at around 1% gains for gold and ~-6% for silver. We have been witnessing inflation being the theme for the market since a very long time and further concerns regarding the same has been affecting all major asset classes. As we know gold is a hedge against inflation and as the price pressures continue to rise we are seeing support in prices at lower levels. On the flip side, major central banks have put their foot on the gas pedal to increase interest rate and curb liquidity in the market and this has led to sharp surge in U.S. Dollar and Yields pressuring the safe haven appeal for gold and silver prices. It really is a pickle for the Fed as on one side there are headlines reading the terms like recession and stagflation and on other side price pressure are off the roof, hence gold is see-sawing amidst these two scenarios. There has been an increased volatility in the U.S. Treasury market i.e. Yields across the curve are surging which justifies a downward momentum in bullions. Amidst this hawkish expectation from the Fed, we are also witnessing the real rates (which is the inflation adjusted interest rates) getting into positive territory which also has an inverse correlation with gold prices.

US 10Y Yield spread(%) v/s Gold price($)



Source: Reuters

What to expect from fed?

Surge in inflation is suggesting that the Fed could continue to remain hawkish and also is expected to raise rates at least in the next couple of meetings as energy prices continue to gain momentum. The Fed is under pressure to quickly take its policy rate to the neutral level that neither stimulates nor restricts - and beyond. In its last projection report, the Fed expected that growth in the US could be at 2.6% and 2.0% for 2022 and 2023. On the other hand, jobless rate was predicted to average at the current level of 3.6% this year and the next, before mildly picking up to 3.8% in 2024. Given upside inflation risk and very tight labor markets, monetary policy makers are likely to move policy to a tight stance—where rates stay above “neutral” to better balance the shift back to an upside inflation risk profile.

Meeting Date	Hike Probability (%)							
	125-150	150-175	175-200	200-225	225-250	250-275	275-300	300-325
14/6/2022	4%	96%	0%	0%	0%	0%	0%	0%
24/7/2022	0%	0%	0%	78%	22%	0%	0%	0%
21/9/2022	0%	0%	0%	0%	0%	17%	69%	14%

Source: CME

Outlook

The Fed has realized that it is way behind the curve on inflation and needed to act more decisively. Inflation by all measures has far exceeded the Fed's 2% target and is eroding wage gains. The Fed is likely to raise rates by 50bps in this meeting and there is section which also believes that a 75bps could be on the table at September meeting if inflation doesn’t cool-off in the next couple of months. The dollar is likely to surprise on the upside and could keep the crosses under pressure.

For the Rupee is concerned it could continue to feel the heat and would be weighed down if the momentum continues. Domestic fundamentals too don’t suggest that the rupee could be well supported at these all-time lows. Surge in energy prices, FIIs are net sellers and strength in the dollar index and expectation of higher government borrowing pose a vague picture for the rupee bulls. We expect the fall for rupee could extend from here as well and is headed towards 80 levels in the near future.

The anticipation regarding higher interest rates could continue to see pressure on both gold and silver prices, although there are certain tailwinds like geo-political tensions, supply chain bottlenecks, continued inflationary expectation for this year, weaker economic data and few others. Once the market participants discount the higher interest rate scenario we could see some relief rallies on upside and then move in range. Whereas along with the safe haven fundamentals, silver also has an industrial metal trait, which could help to create a positive story for the metal. Looking at this month, Gold has an important support at Rs. 50,000 and Rs. 48,000 whereas resistance is at Rs. 52,000. On other hand, Silver has an important support at Rs. 60,000 and 58,000 and major resistance is at Rs. 63,000 and Rs. 65,000.

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