State of Play

17 March 2022

Rising oil prices have placed additional pressure on the Federal Reserve to intervene and raise rates. What role does the Federal Reserve play in financial markets and why do their actions and words carry so much importance for investors? Our Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Federal Reserve Act

Previously, State of Play has touched on the history of the Bank of England and the importance the role a central bank has in providing stability for financial markets. The Bank of England was one of the first central banks in the world dating back to the 17th century[1], but the Federal Reserve (the Fed) is arguably now the most influential globally. This week sees the first rate rise from the Fed since 2018 in response to soaring inflation. So, who are the Fed? When was it formed and why is it so crucial to global financial stability?

Until US Congress passed the Federal Reserve Act in December 1913, the American financial system suffered from systemic problems of liquidity and instability, leading to a continuous cycle of bank failures over much of the 19th century.[2] National banks at the time were limited on how many dollars they had available against how many US Government bonds the bank held.[2] Given the US Government borrowed periodically, this system was inflexible and didn't adapt to changes in demand when the economy was either growing quickly, or when unexpected news caused bank customers to worry about the safety of their money and would simply 'run' to the bank to withdraw the lot.[2] In addition, instead of large banks with many branches, America was made up of thousands of small one-off banks who were unable to grow large enough to offer stability or gain enough trust to ward off a crisis when it struck.[2]

Following yet another financial crisis, initially triggered by the devasting San Francisco earthquake in 1906, policymakers decided to take action to solve the constant cycle of financial failure.[2] However, the barriers of political vested interests and national historical bias against large banks made the challenge of finding an agreeable solution somewhat problematic.[2] It took six years to find a suitable plan and another year of fierce political debate before US Congress passed the Federal Reserve Act on 23 December 1913, signed into law by President Woodrow Wilson, delegating key responsibility of money supply and controlling inflation to the Fed, thus providing crucial economic and financial stability.[2] Today the Fed has five key functions, but in my opinion the two most important are to set US monetary policy to promote maximum employment and stable prices alongside monitoring the financial system risks to support a healthy economy.[3]

Federal Reserve Chair

Since being established, the Fed has become powerful, influential, and pivotal to the economic success of the US and the wider global economy. There have been specific periods shaped by the economic environment at the time that have garnered more influence for the institution being led by key individuals playing the role of its Chair. The 1970's saw high inflation and stagnant economic growth which eventually led to Paul Volcker being sworn in as Fed Chair in August 1979[2]. During the 1980's his leadership tackled inflation head-on, and although initially challenging, eventually brought rising prices under control.[2]

Arguably, the most famous Chair in modern times, Alan Greenspan followed Paul Volcker in overseeing the longest economic expansion in US history[2]. Yet, just two months after he took office the stock market crashed on 19 October 1987, and in response he famously said immediately before trading began on 20 October 1987:'The Federal Reserve, consistent with its responsibilities as the nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system'.[2] A 10 year economic expansion followed in part driven by lower interest rates and very supportive monetary policy.[2] In my view, he was probably the Chair that linked so much importance to the language he used and more importantly what the direction of interest rates, financial support, and the health of the economy meant for investors.

More recently the Fed played a critical role in helping navigate both the US and global economy through the financial crisis, working with other central banks to save the global financial system from collapse. Their interventions in cutting interest rates to record lows and creating new money through quantitative easing ensured sufficient liquidity existed so that banks could start to lend to individuals and businesses. This programme of financial support is about to come to an end as interest rates are expected to normalise over time. No doubt the Fed will continue to play a pivotal role in steering the US through what lies ahead whilst being closely analysed by investors and markets around the world.

Market update

Whilst the Ukraine crisis continues, all eyes have been focused on the Federal Market Open Committee meeting this Tuesday and Wednesday. As expected, the committee raised interest rates by 0.25% in the US for the first time since 2018.[4] Whilst markets have been closely observing the war in Ukraine, much of the uncertainty linked to the crisis has surrounded commodity prices and what impact this will have on rising prices. The rate rise has been priced in for some time, but investors are likely to be evaluating the tone of Jerome Powell, the current Fed Chair, in case this indicates a more cautious approach to future rate rises or whether, as expected, the path to normalised rates has begun.

In other news, China has placed the whole of Shenzhen under a six day lockdown following increasing numbers of COVID-19 infections.[5] Stock markets in Hong Kong and China fell sharply as investors are concerned about the knock-on effects to already fragile economic growth and the supply chain problems this may create from shutting down such a crucial port in a key manufacturing hub that supports the wider global trading supply chain.[5] Whilst six days may have a limited impact, markets appear to be jittery in case this is extended for a longer period. Until recently China has successfully limited outbreaks from spreading across the country by locking down whole cities followed by mass testing and strict contact tracing, however, whilst effective it can be very disruptive to economic activity.

The latest UK employment data from the Office for National Statistics (ONS) reveals the largest number of vacancies recorded for the period between December 2021 to February 2022 at 1,318,000.[6] This is an increase of 105,000 from last quarter, with half of the industry sectors showing record highs.[6] However, the rate of growth in vacancies continued to slow down. The latest update from the ONS also stated 'Our most timely estimate of payrolled employees shows another monthly increase (up 275,000) in February 2022 to a record 29.7 million.[6] The unemployment rate decreased by 0.2% on the quarter to 3.9%, while the economic inactivity rate increased by 0.1% to 21.3%'.[6]

Find out more!

Listen **here** to our latest Market Views from our Head of Systematic Research for TAA and Alpha, Stefano Amato, as he shares his thoughts on the impact of the Ukraine crisis on markets.

Note: Data as at 15 March 2022.

[1] Bank of England, 8/03/2022
[2] Federal Reserve Education, 13/09/2021
[3] Federal Reserve History, 15/03/2022
[4] Investing.com, 16/03/2022
[5] Financial Times, 14/03/2022
[6] Office for National Statistics, 15/03/2022

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