Stock selloff is far from forcing the Fed to blink

Those clinging to a decade-old belief that the Fed will mount a rescue of tanking stock markets with a last-minute pushback on the timing of interest rate hikes may be left disappointed.

Equities have nosedived and government bond yields have risen in the runup to

Wednesday afternoon's Federal Reserve policy decision which is widely expected to signal an interest rate liftoff in March and the timing of stimulus cutbacks.

While the rout has since eased, it raised the question: how much pain must stock markets endure before the Fed backstop - or "put" - comes into play? And has that estimate changed?

Named for the hedging derivative used to protect against market falls, the "put" was deployed during previous selloffs, most recently in early 2019 when a market tantrum persuaded the Fed to call time on its rate hiking cycle.

Based on history, Julian Emanuel at Evercore ISI Research reckons the S&P 500 would need to fall by 23.8% from its recent high for the central bank to act. Janus Henderson Investors estimates the put kicks in when declines surpass 15%.

But this time, the need to stamp out inflation running at 40-year highs around 7% may change the equation.

"The Fed will typically only let the risk markets to sell off so much before they feel the need to slow it down a little bit. But now we have to ask, will they allow it go down 20%? Twenty-five percent?" said Jason England, global bonds portfolio manager at Janus Henderson.

While a rebound is now under way, holding off tightening also raises risks the Fed might have to hike more should inflation get out of control. And it would go against policymakers' view that the economy has recovered faster than anticipated.

"The Fed ... because of the current inflation backdrop is not going to be able to blink. That's an issue markets are going to have to deal with," Morgan Stanley (NYSE:MS) strategist Graham (NYSE:GHM) Secker said.

Oil prices have risen, central banks have slowed the rate of money growth injected into economies and on a quarterly basis money supply is shrinking, Howell noted.

"A 10% drop in the markets would be OK, much more than that they may find it very difficult," he said.

Ian Lyngen, head of U.S. rates strategy at BMO Capital Markets, said stock market "fragility" ruled out a 50 bps hike in March, which some investors have predicted.

But, he said, the Fed will proceed with hikes "until something breaks," adding, "it's far too soon in the process for the Fed to be dissuaded by equity investor anxiety."