The Federal Reserve Open Market Committee raised the fed funds rate today by another 0.75%, to a new range of 2.25-2.50%. The vote was unanimous, with no dissents, unlike June's meeting.

The formal statement language changed little, but noted 'recent indicators of spending and production have softened'. However, job markets were still described as 'robust', and inflation remains 'elevated'. The war in Ukraine was again acknowledged for the negative influence on inflation and global economic activity.

In the days prior, the CME fed funds futures market[1] signaled the probability of a 0.75% hike at around 75%, and of a more extreme 1.00% hike at 25%—so it wasn't quite a done deal. The chances of a larger hike had gained steam in recent weeks, with sky-high inflation data pressuring the Fed towards a more hawkish pace, as hinted at by some Fed members during their rounds of carefully-worded speeches. However, drops in consumer inflation expectations and petroleum prices eased that pressure a bit. For the rest of 2022, embedded assumptions still include a 0.50% hike in September, followed by 0.25% each in November and December. This results in a year-end futures market estimate of around 3.50%, in what appears to be the high (aka 'terminal rate') for this cycle. The furthest-out available estimate, July 2023, has actually fallen to around 3.25%—implying a rate pause or cut early next year, presumably in response to recession and policy reversal. As usual, the press conference and upcoming speech circuit will be used for setting the tone on how policy will be handled over the next few quarters, although they remain data dependent.

Importantly, today's fed funds rate now stands at the FOMC's rough estimate of long-term 'neutral', the point where policy is balanced, and deemed neither stimulative nor restrictive. That number has been anchored for years at a nominal 2.5%—consisting of the 2.0% inflation target plus 0.5% of real yield, the latter based on historical tendencies. Of course, that's a moving target, and an imprecise one at that. While this might have been an appropriate ending point for hiking policy not long ago, in raising 0.0% emergency fed funds levels back toward some type of 'normal' rate, this is no longer the case. Treatment of high inflation under classic monetary policy now requires rates to rise above neutral for a time. The key questions now are: by how much and for how long?

The Fed's evaluation metrics remain mixed, in terms of high inflation being offset by strong labor markets, and still not bad, but definitely decelerating, economic growth fundamentals.

<u>Economy</u>: Economic growth has slowed at a faster rate in recent weeks, with today's Atlanta Fed's GDPNow measure pointing to negative Q2 growth of -1.2%. (The first of three official government estimates for Q2 growth will be out tomorrow.) Private sector estimates have been a bit brighter, ranging from a flattish 0% to a positive 2%. The caveat is that negative growth and recessions aren't usually any economist's base case, for a variety of commercial reasons. Regardless of the actual result, growth has fallen back from the faster pace of 2021, with current questions focused on the possibility of recession in 2022-23, and, if so, how severe one could be. With few financial excesses such as high leverage or continued-high asset valuations (with equities in bear market-territory and bonds having adjusted for higher market interest rates), chances of a severe or drawn-out recession remain lower. Moving beyond the immediate few quarters, estimates for GDP growth over the next several years remain around 1.5-2.5%, similar to pre-pandemic trend, and driven by longer-term secular factors.

Inflation: As a key focus of 2022 financial news, the year-over-year numbers have become sadly embedded in memory each month. As of June, headline 12-month CPI of 9.1%[2] has been on an upward trend, with high (but more recently weaker) oil and gasoline prices dominating the result. Core CPI, on the other hand, has decelerated to 5.9%. There is still hope in inflation finding a peak in 2022, and beginning to normalize lower, but it's probably wise to remain realistic. While studies[3] have shown temporary pandemic-caused supply constraints are responsible for up to 50% of current high prices, it could be a process of quarters to years for overall CPI levels to return to a Fed target-like 2%. For 2023 and beyond, CPI estimates remain elevated, at a few tenths above or below 2.5%. However, as seen in recent commentary by Walmart and Target, inventory gluts for particular goods can drive prices down very quickly. The Fed can use monetary policy to drive demand destruction, as rising rates make credit financing more expensive, but it can't help much with supply problems. This is the crux of the Fed's dilemma in fighting inflation, although it's been steadily criticized for not doing more, and sooner. Longer-term, the importance of supply chain resiliency has been acknowledged by Congress through bipartisan support for the CHIPS for America Act, FABS Act, etc. Another positive, noted earlier, is that consumer inflation expectations over the long-term (5-10 years) have fallen back and remain anchored, which lowers the risk of a systemic inflation 'mindset' gaining traction as it did in the 1970s.

Employment: Labor markets have remained the bright spot of the pandemic recovery. High profile nonfarm payrolls and unemployment indicators remain strong, with a continued lack of available/willing workers vs. the number of job openings. This strength has been a constant; however, there are some signs of easing at the margin, such as in rising jobless claims, and anecdotal news of hiring freezes and even some layoffs in a few industries, such as technology. This is far from widespread, though, with many sectors plagued by labor shortages. Still, the labor market can only operate so strongly for so long, and can't improve much further from here, so the next natural step would be a pullback.

Financial markets appear to be pricing in the rising risks of recession, which has almost superseded the earlier worries about inflation and Fed policy. Markets climb a wall of worry, as it's often said, although the worry tends to change. The Fed is still in hawkish mode, no doubt, but there is a rising realization the Fed can only rate rates so much without causing a recession. (History shows 'soft landings' are possible but not typical.) That scenario is what has put a potential cap on the fed funds terminal rate somewhere around 3.5%, give or take a quarter- or half-percent, based on where inflation stands a few quarters from now. Markets do appear to feel more comfortable with the realization that this terminal rate is contained and not 'unlimited'.

Items of market focus include all of these factors: continued concern over high inflation (perhaps until it peaks), a hawkish Fed and chances for policy error, continued supply disruptions from China and Ukraine/Russia (although signs of easing have been seen), as well as the slowing economy, impact on corporate profits, and rock-bottom consumer and business sentiment. While negative sentiment indicates a real risk of consumers and businesses pulling back on spending and hiring in anticipation of conditions worsening, the already-extreme levels (as low as 2008 in some cases) indicate an overshoot. The pandemic years and devastation in Ukraine have cast a negative shadow over the global mood. This is similar to the Global Financial Crisis in that sense, where it took some time for optimism to return. Other regions of the world, such as Europe, are in a much more sensitive place, with recession increasingly likely, but this is not in the Fed's direct mandate unless it starts to affect U.S. conditions.

If things can't get far worse than a mild or even moderate recession, the historical tendency for financial assets to fare well when conditions move from seemingly 'bad' to 'better' (even though they aren't that bad), may help market prices start to reflect the shift. This has tended to happen well before investors 'feel better'. It's also why waiting for 'good' to become 'great' can end up being costly, in terms of lost investment returns, as the timing never coincides. Ironically, a Fed acknowledgement of slowing conditions taking precedence over inflation worries could be an upward catalyst for both stocks and bonds, as it would give better clarity around interest rate expectations.

A ‘peak’ of fed rate hikes and inflation could provide, and has been providing, more clarity to the bond market, as longer-dated yields move differently than short-term yields and could even respond more robustly lower should the economy slow further. The U.S. treasury 2y-10y curve inversion reflects this view. Stocks, with valuation multiples near their multi-decade averages, could be driven by sentiment in the near-term (again, it couldn’t get much worse—a potential contrarian bullish sign) and earnings results on a longer-term basis. Near-term earnings growth remains a question for the remainder of 2022, and could provide more fuel for market volatility, but a troughing in earnings expectations could cause markets to again look forward to the next cycle, and potentially quickly.

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Sources:
[1]CME Group (https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html)
[2]U.S. Bureau of Labor Statistics
[3]For instance, Federal Reserve Bank of San Francisco (https://www.frbsf.org/economic-research/indicators-data/supply-and-demand-driven-pce-inflation/)