The Federal Reserve Open Market Committee raised the fed funds rate today by another 0.75%, to a range of 3.00-3.25%. The vote was unanimous, with no dissents.

The formal statement language was hardly changed at all, only noting an upgrade from 'softening' to 'modest growth' in spending and production. The Fed has hiked by a total of 3.00% so far since they began in March, a pace twice as quick as the 12 months on average for that pace over the last 40 years. For perspective, the Fed has already hiked beyond what took three years to accomplish during the last 2015-18 cycle.

In the weeks prior to the meeting, the CME fed funds futures market[1] signaled the rising likelihood (~85%) of the 0.75% move, with 1.00% being a less likely outcome. Similarly, rate hike expectations for Nov. and Dec. have also been risen, to 0.75% and 0.50%, respectively. The assumed fed funds terminal rate has drifted up to around 4.50% by mid-2023. However, new expectations for Dec. 2023 show a drop to 4.00-4.25%, which implies the Fed will have gone 'too far' sometime next year, requiring a reversal in policy (a reflection that monetary policy operates with a lag). The dot plots released today show a similar pattern, with a peak next year, but in a wide and symmetric range of 4.25-5.00%. Of course, these predictions all have to be taken with a grain of salt, but are a useful snapshot of current opinion.

The Fed's evaluation metrics remain mixed, in terms of high inflation being offset by strong labor markets, and decelerating (but still not terrible) economic growth fundamentals, or at least enough to be able to handle the hikes, as the Fed puts it.

<u>Economy</u>: The Fed's newest Summary of Economic Projections (SEP) shows GDP growth expectations for 2022 falling from 1.7% in June to 0.2% this month, and a deterioration of a few tenths to 1.2% in 2023 and 1.7% in 2024. No doubt, slowing has occurred in parts of the economy, such as housing, which the Fed has some control over via financing rates to reduce demand. Other key indicators, such as ISM manufacturing and services, remain in expansionary territory and refute calls of an upcoming near-term recession. Still, with the Fed tightening at this rapid pace, there are more headwinds to the economy than tailwinds. The path for a 'soft landing' is still there, but increasingly narrow, with recession the rising base case.

<u>Inflation</u>: Trailing 12-month CPI for August decelerated to 8.3% on the headline side but ticked up to 6.3% for core (ex-food and energy)[2]. Core was a disappointment, due to hopes a peak had been reached and we'd be on the downhill slide by now (which explained the very negative stock market reaction). The Sept. SEP indicates PCE inflation expectations ticking higher by a few tenths to 5.4% in 2022, 2.8% in 2023, and 2.3% in 2024. There is hope, with estimates for 2023 and beyond showing signs of inflation pressures fading, but this remains a month-to-month data point in the near-term. Supply-side conditions have improved, with loosening manufacturing and transportation links, although labor shortages remain a problem. Lately, falling oil/gasoline prices have helped, while the 40% of CPI dedicated to shelter costs may see continued pressure from rents and home prices. On the demand side, the money supply (such as M2) remains large, but expansion has slowed, now requiring time for the liquidity to dissipate through the economy. To the effect that this has buoyed commodity and asset prices and wages, it will likely continue to take several more quarters to years for some degree of the old normal.

Employment: Labor continues to remain a bright spot, with payrolls and job openings high and unemployment low. At the same time, it's been a problematic mix for policymakers as a shortage of workers and job-worker mismatch has complicated the market. The pandemic has been a major disruptor to the labor force size, due to the impact of early retirements, lower immigration levels, continued home care needs, and large stimulus payments. (Finding and measuring some of these 'missing' workers is an ongoing mystery to economists.) The SEP showed the unemployment rate rising a tenth to 3.8% in 2022, and several tenths for upcoming years—4.4% for both 2023 and 2024. One growing thought is that the Fed keeps rate hikes going until unemployment starts to rise, but this is only a single data point among several moving parts.

The Fed has been facing criticism for months, and seems it can do nothing right. Firstly, it has been accused of waiting too long to start raising rates, after inflation was well ignited. In their defense, though, they've been in the same camp as many other economists in believing certain inflation inputs were more transitory than they've turned out to be. This view still may not be completely off-base, other than normalcy taking far longer than hoped. Secondly, the Fed has been accused of being potentially too stubborn in promising a hawkish hiking policy in place 'or bust', with an apparent disregard for economic slowing that normally spurs a pause for reflection, or even reversal. There aren't easy answers to either of these issues, as the Fed is forced to act in real time, using blunt monetary policy controls to alter the course of a huge slow-moving ship through constantly changing seas. Hiking rates to cause 'demand destruction' is one of the few tools central banks have to work with. (Fiscal policies are completely out of their control, as Chair Powell reminds us.) Thirdly, there is an argument that the money creation since the financial crisis ($9 tril. Fed balance sheet) has been too robust, with less flexibility and predictability going forward due to this size.

Per its previously stated plans, the Fed has also ramped up the balance sheet reduction program or 'quantitative tightening' from $47.5 bil./mo. to $95 bil./mo. This hasn't been discussed much since, as it's assumed the Fed would like to keep this under the radar, in an eventual return to more normal balance sheet levels, and avoid disrupting longer-term bond market yield levels. However, there are signs of lower liquidity in treasury bond markets, which could result in additional volatility.

The positive news for equity markets is that, historically, once a peak is reached in trailing inflation, returns tend to turn quite positive (and above-average). Fixed income markets tend to track Fed policy shifts, although long-term rates have settled into a tighter range—implying markets are seeing a realistic end point for long-term yields. (Ten-year treasury rates have a tendency of topping out near cyclical peaks in Fed-driven short rates, which is why curve inversions tend to stay somewhat contained.) Higher rates result in higher multi-year bond total returns, as well as provide a better potential for price return if rates again need to fall a bit to fight a waning economy. The higher bond rates rise, the more bonds are again coveted for both income and 'flight to safety' uses.

There is art in addition to science in these discussions, and the general public doesn't tend to follow interest rates dynamics closely, so a fear remains that levels could spiral out of control—essentially that the Fed keeps hiking indefinitely. Many Americans remember the early 1980's, when bond yields broke out of their historical range towards 20%, anchoring that fear. However, several economic drivers (demographics, productivity, globalization, petroleum reliance) have shifted from that time. There is a point where a sufficiently-high terminal rate puts the brakes on inflation, but as much or even more so, to the economy. Rates and inflation don't operate in a vacuum.

This could be looked at more broadly, in that a return to 'normal' is welcome. Although it may be surprising, for the last few centuries[3], developed economy nominal interest rates have fallen in a rough range of 3-6%. The emergency policy after the Great Recession had pulled cash rates down to 0% with 10-year yields below 3% for most of the last decade. It's been argued that such artificially low levels over secular periods can destabilize an economy through increased incentives for risk-taking. Bond yields closer to 'average' are far healthier as a tool to keep economic growth, inflation, and financial risk-taking in proper balance.

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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]Based on academic work at the Bank of England