The Federal Reserve Open Market Committee raised the fed funds rate today by another 0.75%, from 3.00-3.25% to 3.75-4.00%. The vote was unanimous, with no dissents.

The formal statement language was hardly changed except for the addition of two lines, which provide a small clue to future direction. These note that 'ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent,' and the committee will 'take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments.' Importantly, these provide a potential off-ramp for tapering off of the 0.75% 'jumbo' hikes.

Over the last week, the CME fed funds futures market[1] signaled the high likelihood (~90%) of the 0.75% move. For the next meeting in December, probabilities are almost evenly split between a 0.50% and 0.75% hike. By March 2023, chances are also mixed, but average ~0.50% more in hikes to around 5.00%—a level that has ticked up over the past few weeks. That rate expectation is little changed through June, implying a possible Fed pause at that assumed terminal rate. However, by Sept. and Dec. 2023, markets are still pricing in one rate cut (-0.25%) or even two (-0.50%). Probabilities change often, but provide a decent guess on today's sentiment. Markets have been looking for a shift lower in rate hawkishness.

For major developed countries over the past 50+ years, the average hiking cycle lasted just over a year, with a median cumulative amount of only a few percent in total. Interestingly, hiking cycles have tended to end not far from ultimate peaks in year-over-year inflation. Also importantly, peak rates have not stayed at those elevated levels for long, with easing occurring within a year following the final hike. History does not always repeat, but has tended to rhyme.

Economy: Despite fears of growth teetering on the brink of recession, being negative for Q1 and Q2, positive 2.6% Q3 growth cast off imminent concerns. For Q4, the most recent Atlanta Fed's GDPNow measure pegs estimated growth at a similar 2.6%, with the Blue Chip economist estimates showing a median expectation of about 0.5%, within a wide range from a contractionary -1.5% to positive 2.0%[2]. Investors had been worrying about whether or not we're already in a recession; concerns now have again moved back to 'good news is bad news', in that plugging along at a still-positive growth rate reaffirms to the Fed that a rapid pace of rate hikes is something the economy can handle. (Of course, since hikes operate with a lag, that is not yet confirmed.) In reviewing a broad brush of estimates, growth expectations over the next several years have been downgraded to around 1.0-2.0%, below the 2.0-2.5% average for the 2010-2019 decade before Covid. Lower growth has a tendency to pull down inflation as well as interest rates.

Inflation: Trailing 12-month CPI for September decelerated to 8.2% on the headline side but core (ex-food and energy) ticked up a bit to 6.6%[3]. The preferred Fed measure, PCE, is lower due to a difference in composition, but all indicators continue to run hot. There have been some signs of easing in recent months, particularly in goods, as supply chain and transportation bottlenecks have improved, but services inflation has been increasingly sticky, along with upward pressure from wages. It isn't clear yet what the 'right' inflation number is that would provide the Fed more comfort in pausing policy, but we haven't seen it yet. The general theme is that inflation has proven far stickier generally than many economists have expected.

Employment: Although there could be some loosening at the edges, labor markets remain tight. Job postings are easy for companies to pull back on, while actual layoffs are harder, with more necessary business planning involved. Instead, we first often see a shorter workweek, slower wage growth, etc. Also, some of this labor strength has become potentially structural, with a shrinking of the labor force due to a number of factors, which could keep conditions tight and wages higher for a longer stretch than anticipated. For financial markets, these tight readings have kept sentiment hawkish, with a more sustained break in labor markets possibly needed for a Fed pause.

The Fed has communicated a hawkish path for the rest of this year, committed to stomping out inflation at all costs, even if it forces the economy into recession—causing self-described 'pain' for a while. This is based on the belief that inflation becomes much harder to fight over time if it becomes entrenched into expectations. In reviewing central banker recollections of the 1970's inflationary episode, it was clear that political pressures were far more dominant in keeping fiscal and monetary policy easier than it should have been. In fact, comments by former Fed chair Arthur Burns allude to these timeless cross-currents and challenges. Fortunately, today's Fed has been generally left alone to do their work, despite fiscal decisions by Congress that seem to have fueled at least some of the inflation problem.

A tightening policy is not open-ended, however. Rising rates have obviously impacted bond and stock markets, but also business lending and housing. If rate levels become overly restrictive on and/or damaging to the economy, particularly if the Fed sees any improvement in inflation measures, the cycle could finally see a peak. The uncertainty is about where that level lies, whether it's 4.00%, 4.50%, 5.00%, or some other number. The current inversion in the U.S. treasury yield curve points to this expectation for rates to ultimately fall back, notably over the next decade as the 10-year treasury has struggled to get above 4.00%. While the Fed will pause at some point, they are also not interested in seeing a coincident 'easing' in financial conditions (which include not only interest rates, but also credit spreads, U.S. dollar exchange rate, and risk asset prices).

There have been other side effects from the Fed hikes, including a stronger U.S. dollar. While currency fluctuations can be driven by a variety of factors, USD strength has persisted due to U.S. rates starting higher and rising faster than developed economies in Europe, remaining the global 'safe haven'. Having a strong currency may seem like a positive, but it can be troublesome for both sides. For U.S. companies, particularly with large international revenues, it makes products sold abroad more expensive, so depresses exports. For other countries, imports from the U.S. are more expensive, and for countries borrowing in dollars (particularly emerging markets), debt balances rise. From an investment standpoint, it's been problematic for U.S. investors in unhedged international stocks and bonds, as a weaker foreign currency lowers returns on a dollar-for-dollar basis. Then again, no tree grows to the sky, as it's said in financial markets. Peaks in the dollar historically have been associated with troughs in global economic growth, as well as peaking in Fed rate cycles. A cycle shift where the dollar sees a peak and pulls back could be directly positive for foreign investments. However, this may take some time to unfold, with global geopolitical difficulties persistent this fall.

Most asset classes have been challenged in 2022, with stocks remaining in a bear market, and bonds experiencing their largest declines in decades. From a contrarian perspective, a significant piece of good news is that sentiment for risk-taking remains low. Looking ahead from such levels historically has tended to be positive for investors willing to take risk at times of such pessimism. Valuations for U.S. equities are lower than last year, but not as low as seen in some recessions (keeping in mind we're not in a recession yet), while foreign stock valuations do reflect recessionary conditions. Higher bond yields have significantly risen, which raises forward-looking returns to levels not seen in many years. Bonds could provide more contribution, diversification, and 'balance' to portfolio returns in years to come, which reflects a normalization in these market rates from near-zero.

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Sources:
[1]CME Group (https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html)
[2]Federal Reserve Bank of Atlanta (https://www.atlantafed.org/cqer/research/gdpnow.aspx)
[3]U.S. Bureau of Labor Statistics