Economic commentary from the Investment Advisory Group

Fed rips off the bandage with three-quarter point rate hike

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Executive summary

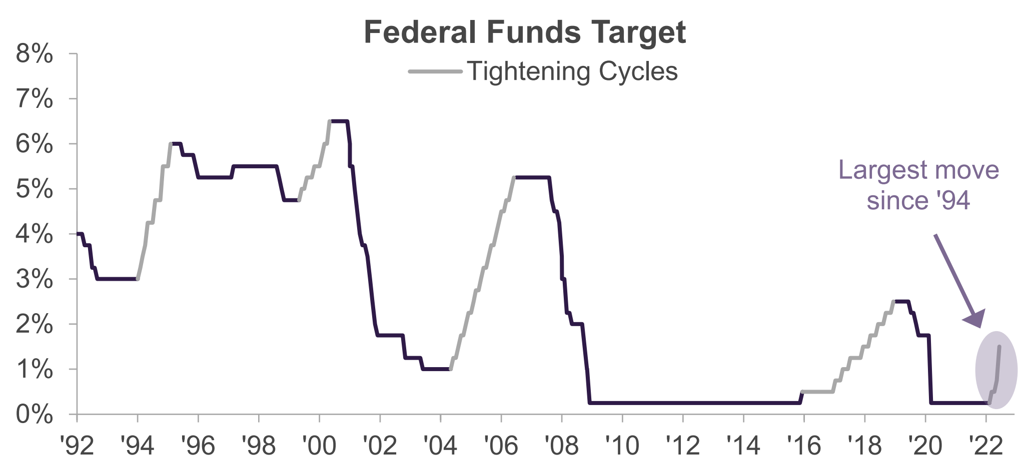
The Federal Reserve (Fed) raised interest rates by three-quarters of a point (0.75%), the largest increase since 1994.

The move was widely expected, but the size wasn't, although Fed officials leaked the possibility of a three-quarter point hike to the media days before the meeting. It underscores the Fed's nimbleness to adjust to incoming economic data, particularly hotter inflation readings. More importantly, the rate increase was a dramatic shift in action, clearly showing the Fed's determination to aggressively address inflation.

Yesterday's market reaction was largely positive as stocks and bonds reacted positively; however, both appear to be giving back most of those gains in early trading today.

While the U.S. economy remains on solid footing currently, intensifying inflationary pressures and dramatically higher interest rates place additional stress on consumers and businesses going forward. By Chair Powell's own admission, a relatively narrow path exists to tighten policy in the face of intensifying inflation and still deliver a soft-ish economic landing. We agree.

This was the third interest rate increase in this cycle, and the largest since November 1994.



Sources: Truist IAG, Federal Reserve Board

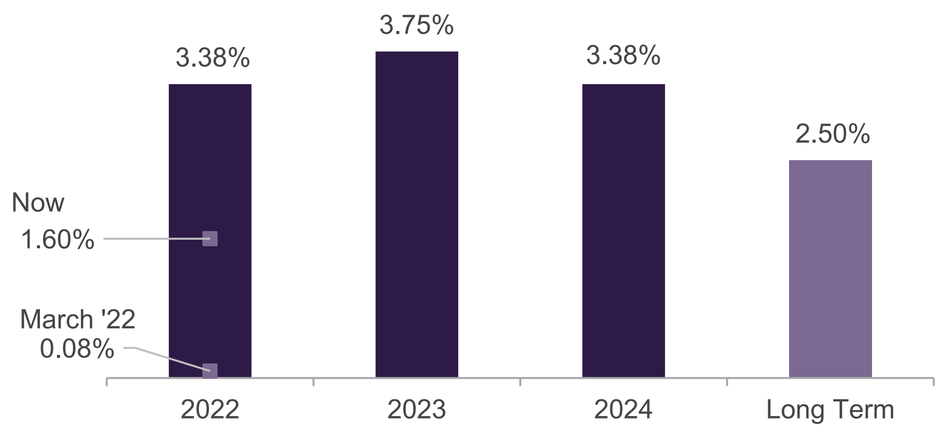
What happened

At its June rate-setting meeting, the Federal Open Market Committee (FOMC) agreed to increase its target range for the federal funds rate by three-quarters of a point (0.75%) to a range of 1.50% to 1.75%. It was the largest increase since 1994 and the third increase in this cycle.

Additionally, the FOMC released its June statement of economic projections, which sees slower economic growth, a rise in the unemployment rate, and a faster improvement in inflation. Most notably, the committee dramatically upped its projections for where it expects the federal funds rate to be by year-end 2022 compared to just three months ago.

There has been a sharp increase in the Fed's rate projections since this past March.

FOMC members' federal funds rate median projection



Sources: Truist IAG, Federal Reserve Board. Year-end upper bound figures shown.

During the post-meeting press conference, Chair Powell maintained a decidedly hawkish tone. Many questions related to the size of this hike and future moves (e.g., half-point versus three-quarter point) with Powell reiterating the committee's data dependency. Yet, he revealed that inflation expectations, which have been rising substantially according to several different measures, were a key determinant in this three-quarter point move.

While Chair Powell noted tightening financial conditions as a result of higher interest rates, he made it clear that whether the U.S. economy falls into a recession depends on many factors beyond the Fed's control – such as extreme spikes in commodity prices, especially crude oil. He also pointedly corrected a reporter that asked if the Fed was trying to induce a recession to bring down inflation.

Our take

The U.S. economy remains on solid footing currently based on four key metrics – production, sales, incomes, and jobs. The latter remain very strong. That said, financial conditions have dramatically tightened in a very short period. For instance, the national average for a 30-year fixed mortgage has nearly doubled this year, jumping to 6% from 3.3% at the start of 2022 and a more than full percentage higher than any time in the past decade. Housing activity has universally collapsed in the past three or four months, depending on the metric.

Additionally, inflationary pressures – chiefly spiking crude oil – have increased of late. Global crude oil markets are trying to reconcile excluding Russian crude oil as a result of the European Union's embargo on most Russian oil imports by the end of 2022. This is a gamechanger in our view. And, as Chair Powell noted, the Fed has practically no influence on crude oil production.

Bond market reaction

In the immediate aftermath of the largest rate hike in 28 years, U.S. fixed income markets found solace in a few developments. For one, Powell's claim that he doesn't expect 75 basis point rate hikes to become the norm projected confidence the Fed could dampen inflation without an extreme escalation in its tightening plans. Second, Powell flatly stated the Fed does not want to induce a recession, though he acknowledged it will require a delicate balancing act. Third, traders were encouraged that the Fed wants to maintain a relatively smooth cadence to raising the federal funds rate. Lastly, after pledging to stay nimble to incoming data, the Fed was able to deliver a more aggressive rate hike that was both largely anticipated and just four trading days after an exceptionally hot inflation print. 2-year and 10-year U.S. Treasury yields each fell 19 basis points (0.19%), closing at 3.19% and 3.29%, respectively.

With the federal funds rate at 1.75% and the committee's projection of 3.375% by year-end 2022, it implies that the Fed would hike rates an additional 1.625%, which is roughly 1.5% higher than it expected in March. This change is consistent with our view that U.S. yields will continue to rise, though we believe the majority of the move this cycle has already unfolded.

Additionally, such an abrupt shift in executed policy relative to the central bank's previous guidance is creating uncertainty over officials' ability to accurately predict policy decisions. Despite Powell's optimism the U.S. economy can endure the Fed's projected tightening, traders are less convicted. The 2/10-year yield curve now stands at just 15 basis points and has inverted briefly in recent sessions.

Bottom line

Intensifying inflationary pressures and dramatically higher interest rates pile on additional stress on consumers and businesses going forward. That makes for a relatively narrow path for the U.S. to achieve a soft-ish economic landing. Accordingly, tightening financial conditions will crimp growth going forward.

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