Truist Advisory Services, Inc.

Fixed income perspective from the Investment Advisory Group

Fed maintains singular focus on inflation fight

July 27, 2022

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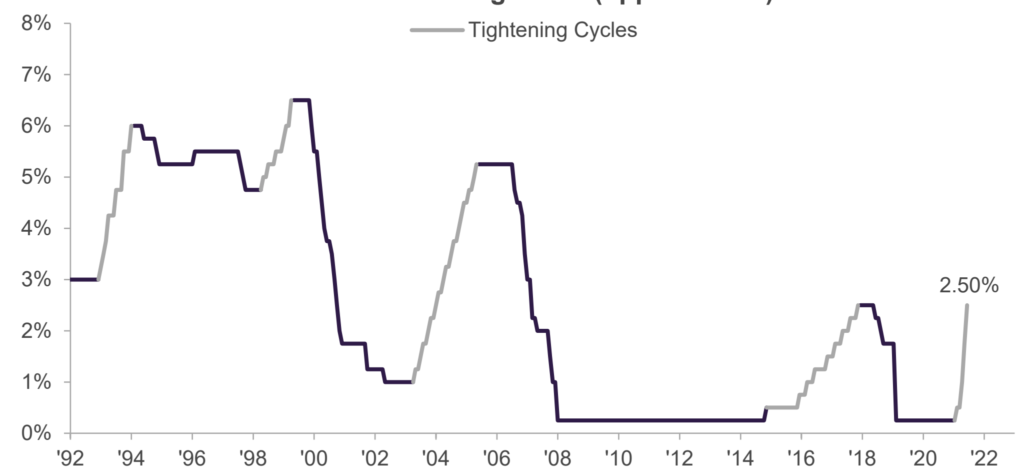
Executive summary

- The Federal Open Market Committee (FOMC) raised the fed funds rate by 0.75% to a **target range of 2.25-2.50%** in a unanimous vote.
- The latest FOMC statement acknowledges the **weaker trends emerging in spending and production activity**, while highlighting the labor market's strength over the past several months.
- Chair Powell warned the Fed's forward guidance about **policy changes are likely to become less clear**, a shift that increases the Fed's flexibility but reduces transparency.
- Immediately following the decision, the **U.S. Treasury curve steepened** as Chair Powell stated the policy rate had reached a neutral setting and future hikes were not set in stone.
- With a meaningful lag existing between policy changes and their economic impact, the **Fed's inflation fight will further weigh on economic activity in the months ahead**.

This was the fourth Fed funds rate increase of the tightening cycle and the second consecutive 75 basis point hike.

Federal funds target rate (upper bound)



Data source: Truist IAG, Federal Reserve Board

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What happened

At its July 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 2.25% to 2.50%**. This is the fourth rate increase in the current tightening cycle and the Fed's second consecutive 0.75% hike. Before the June FOMC meeting, the last time the Fed delivered a 0.75% increase was in 1994.

Notably, the FOMC statement acknowledged that spending and production activity has slowed significantly since the previous rate decision. However, the Fed's concerns over these slowdowns are mitigated by resilient aggregate demand and ongoing strength in the U.S. labor market.

In his post-meeting press conference, Fed Chair Jerome Powell emphasized two key themes. First, Fed officials are still extremely focused on tightening monetary policy to "moderately" restrictive levels to bring demand back in balance with available supply and cool inflation. Secondly, he signaled the Fed's forward guidance will likely become less transparent going forward and the size of future rate increases will depend on how economic data evolves. **Chair Powell also stated that he does not believe the U.S. economy is currently in a recession**, pointing to strong job growth and rising wages as meaningful bright spots that are inconsistent with fears over an imminent recession.

Our take

The Fed's second consecutive super-sized rate hike likely takes the fed funds rate to a level close to a "neutral" setting – one that the Fed believes should neither slow nor accelerate the U.S. economy over the long-term. We expect the Fed will continue to raise its benchmark rate to roughly 3.25-3.50% between now and year end. This is a level consistent with the Fed's goal to increase the policy rate to a moderately restrictive setting.

The Fed is probably eager to raise rates at a slower pace over the next few meetings, but that will require softer incoming inflation data. However, monetary policy is well known to work with a delay. The impact of the central bank's rate hikes so far this year will take time to seep into the system and reveal their ultimate impact. Thus, the aggressive tightening strategy thrust upon the U.S. economy by the Fed will contribute to more economic challenges and uncertainty that are already on the rise.

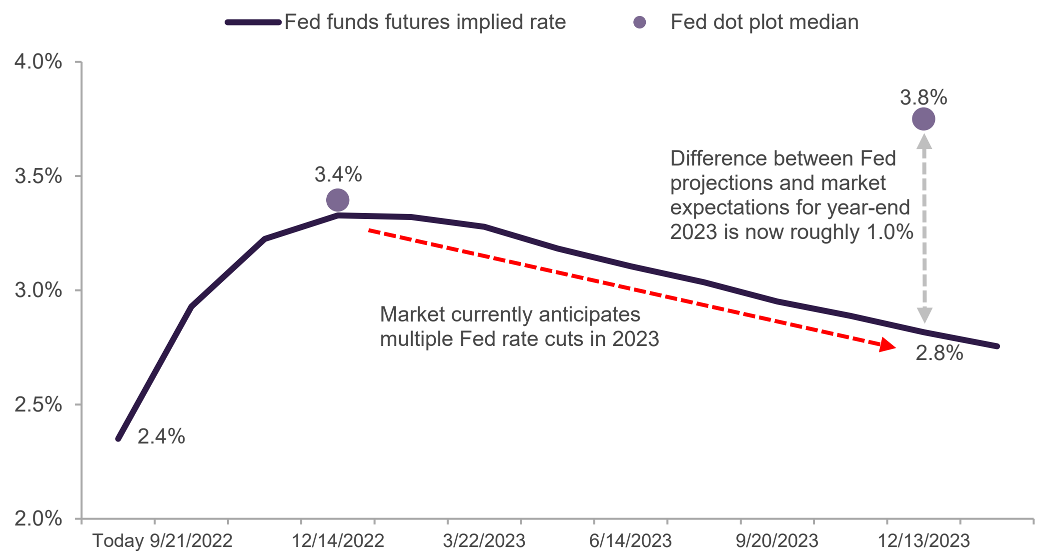
In an effort to maintain ample policy flexibility, the Fed is doubling down on its pledge to remain wholly data-dependent going forward. Simultaneously, it is warning that policymakers' **forward guidance (i.e., what it plans to do next) will be less clear for meetings ahead**. In an effort to avoid a market tantrum, the Fed has been very careful to plainly state its policy intentions and build a long runway before their execution. But today's uncertain and fast-evolving economic conditions are making it very difficult for the Fed to successfully telegraph policy.

This likely has two key implications. For one, the Fed may be less beholden to its projected tightening path on a meeting-to-meeting basis. This should add helpful pages of data-dependency and nimbleness to the central bank's playbook. And two, financial markets may exude higher volatility around future monetary policy decisions with less clarity provided ahead of time.

For example, Chair Powell mentioned that as of the June meeting, Fed officials roughly expected the fed funds rate to reach 3.25-3.50% by the end of this year and 0.25-0.50% additional increases in 2023. Currently, the market is not following this path. There is strong agreement with the Fed's rate projections through the end of this year; however, fed funds futures trading shows the market consensus expects rate *cuts* will arrive around the middle of next year. In other words, either the Fed's economic expectations from their June FOMC meeting are too sanguine on the economy or market participants are too pessimistic. Regardless, this divergence raises the risk of policy blindsides that tend to fuel periods of elevated volatility.

The divergence between the Fed's rate projections and market-based expectations raises the likelihood of persistent volatility.

Fed funds futures vs. Fed projections by FOMC meeting date



Data source: Truist IAG, Bloomberg

Chair Powell repeatedly shot down the notion that the U.S. economy is already in a recession. When asked if the Fed would accept a recession as the cost of bringing inflation under control, he avoided a direct answer but assured listeners that the central bank is focused on tamping down demand while trying to engineer a soft economic landing.

We agree that a recession in the near-term is not a foregone conclusion, but recession risk is rising despite a remarkably strong labor market. In fact, the last time the Fed raised rates this aggressively in the mid-1990's, a recession was averted. That tightening cycle remains one of the few exceptions. The ongoing crisis in Ukraine, COVID lockdowns in China, and generationally high inflation at home are creating a very narrow path for success. **The longer inflation remains problematic, the more difficult it will be for the Fed to achieve this balancing act.**

Market reaction

Immediately following the press release, yields held relatively stable given the well-telegraphed nature of the 0.75% rate hike. Fed funds futures fully priced in a 0.75% hike weeks ago. Once the press conference began, trading intensified. The policy-sensitive 1- to 5-year portion of the U.S. Treasury yield curve declined by 7 to 9 basis points (0.07-0.09%), reacting to Powell's suggestion that rate hikes were not on autopilot and would be adjusted as needed. The longer end of the curve actually rose on the day, slightly steepening the overall curve. The 10-year U.S. Treasury yield ended the day near its starting point, falling 3 basis points (0.03%) to 2.78%. U.S. equities responded well in the immediate aftermath of the Fed announcement. Traders took comfort that 0.75% rate hikes had not become the Fed's default decision. The S&P 500 advanced more than 2.5%, though the U.S. dollar weakened relative to most global counterparts.

Ahead of the Fed decision, the U.S. Treasury yield curve extended its recent flattening trend. Yields between 0 to 2 years have risen dramatically this year in response to intensified Fed rate hike expectations and near-term inflationary pressures. However, since mid-June, longer-dated yields have fallen sharply as global growth concerns spread.

The 2/10-year U.S. Treasury curve remains inverted (i.e., the 10-year yield is lower than the 2-year yield) by roughly 0.20%. It remains near its deepest inversion in more than two decades. The 3-month/10-year yield curve – the Fed's preferred yield curve indicator – has flattened dramatically in recent weeks, but remains positively sloped. Just 0.40% currently separates yields at these two points in the curve. However, this segment of the yield curve was 1.80% steeper less than three months ago, a stark byproduct of the Fed's aggressive rate hikes.

While the U.S. yield curve is not a perfect predictor of future recessions, it has amassed a relatively strong track record for signaling future economic malaise. A 2/10-year yield curve inversion has forerun the last 6 U.S. recessions by an average of 16 months, while signaling a notable false positive in 1998. **The yield curve is just one market indicator, but its recent behavior warrants caution.**

Bottom Line

Stubbornly high inflation and dramatically tighter financial conditions will continue to add stress on consumers and businesses going forward. While the Fed wants to nurture a healthy economic environment, recent inflation readings are forcing the Fed's very aggressive policy response to continue. **That leaves a relatively narrow path open for the U.S. to achieve a soft-ish economic landing.**

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CN2022-4500992.1 EXP03-2023