# Pulse

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## Inflation remains the priority amid slowing growth

The Federal Reserve did not surprise and raised its target range for the federal funds rate by 75 basis points to 2.25%-2.5%, referring to high inflation as its primary concern[1]. A strong labour market supported a hawkish tone overall during the press conference; the slowing economic momentum was noted though. Since the crucial September FOMC meeting where the Fed could decide to curb rate hikes, we would like to make some observations to keep in mind during this eight-week period.

### Closer to the Fed's estimate of the neutral rate[2]

The second straight 75 basis points hike that was delivered during last week's FOMC meeting brought the policy rate closer to the central banks estimate of the US economy's neutral rate, which is unobservable but assessed to be on the 2.5% to 2.75% range. Indeed, the US monetary policy is still accommodative with respect of this neutral rate measure. Fed Chair Jerome Powell did acknowledge this time though that the growth outlook was deteriorating, citing slowing consumer and business spending. However, he stated that the FOMC would like to see some months of easing inflationary pressures before slowing its policy tightening. As such, additional rate hikes in upcoming meetings were signalled on the back of the still tight labour market, which is helping to support price pressures. Overall, the FOMC continues to prioritize inflation over growth as Powell's statement downplayed the deceleration in activity. As a reminder, on the latest Summary of Economic Projections (SEP) released in June, FOMC participants' median projection for the federal funds rate was 3.4% and 3.8% for 2022 and 2023, respectively (see Figure 1). This means that just six weeks ago, policymakers were thinking that the policy rate would need to go about 90 basis points above its neutral level into restrictive territory to be able to stabilize prices. On these lines, Powell expressed confidence that demand would continue to run above supply and that policy rates will need to move to at least into "moderately" restrictive territory.

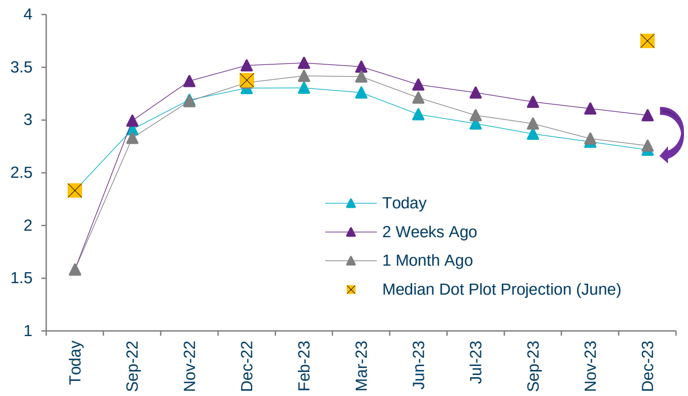
### Towards a weaker forward guidance

Abandoning the forward guidance seems to be the "new normal". Indeed, after the ECB did so during its last policy meeting, **Chair Powell announced that the Fed will no longer provide clear forward guidance on upcoming rate hikes and, instead, will adopt a meeting-by-meeting approach**. In the same way as we argued for the ECB, this move is likely explained by the atypical nature of the economic cycle we are experiencing. Since March 2020, the volatility of the business cycle has remained historically elevated, what has increased central banks' dependency on the incoming economic data. Powell stated that after front loading rate hikes the FOMC needs to assess interest rate decisions with a **greater degree of flexibility**. This starts by avoiding being conditioned to previously signalled moves and adopting a progressively more "wait and see the data" mode. However, Powell did provide some insight into how the FOMC might be starting to think about the near future. He mentioned a "slowdown" in hikes would be appropriate "at some point", which although it being quite vague it did sound marginally more dovish. In fact, it triggered broad based rally as markets priced in a somewhat less aggressive path for rate hikes. Nonetheless, depending on incoming data, "another unusually large hike" was left on the table for September. Ultimately, we believe that while this new stance appears a sound strategy it does increase overall uncertainty and, consequently, volatility. Economic data released until September 21 will be of remarkable importance to gauge what the FOMC might do next.

### What to expect going into the Fall

Two more CPI and job reports will be issued before the next FOMC meeting in September and it is worthy to bear in mind we have been constantly surprised on the upside by both reports. In addition, the 2022 Economic Policy Symposium in Jackson Hole (August 25-27) is usually used by policy makers as an important interim event to guide market expectations.

Figure 1: Expected Federal Funds Rate – Market vs. Dot Plot
(Sources: Bloomberg & NIM Solutions)




Given the increasing evidence that economic growth is slowing and the Fed's likely persistence in tackling inflation, we see markets becoming progressively more positioned for a recession. In fact, we have already seen a material decline in rate hikes expectations during the last weeks (see Figure 1). That is, we have seen long duration assets outperforming short ones, including investment grade against high yield. **Our base case anticipates another 75 basis points hike in September as the Fed prefers risking inducing a more or less pronounced recession to ease the labour market's tightness than having to deal with an arguably costlier stagflationary environment**.

In the meantime, markets are likely to bet against such large rate increases and, thus, bet against the Fed. The yield curve should invert further as the long end continues to price slower economic activity and volatility in the fixed income market is likely to remain elevated if not increase over the coming months. Since June, the Fed has let a maximum of USD 47.5 billion Treasury bonds and mortgage-backed securities mature per month as part of its quantitative tightening (QT) process. In September, the Fed is set to increase the pace to a maximum of USD 95 billion per month, or roughly USD 1 trillion per year. This would be almost double the amount than during the Fed's first QT attempt between 2017 and 2019, which needed to be halted in September 2019 due to liquidity issues in the repo market.

[1] The inflation rate in June reached 9.1% yoy, and the personal consumer expenditure index exceeded the expectation for the T2.22 and came it at 6.8% yoy.
[2] The neutral rate is the theoretical federal funds rate at which the stance of Federal Reserve monetary policy is neither accommodative nor restrictive. It is in line with the short-term real interest rate consistent with the economy maintaining full employment with associated price stability (Source Fed of Dallas - Speeches by Robert S. Kaplan, 2018).

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