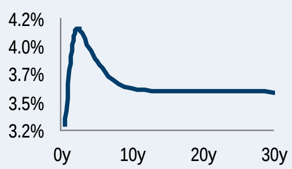
September 21, 2022

ANATOMY OF A POLICY ERROR

- The Federal Reserve raised overnight interest rates 75 basis points to a range of 3.00–3.25%, the third consecutive such hike
- We are on the verge of a policy error whereby aggressive rate hikes will “break” some markets; emerging market FX looks vulnerable
- At this point, a hard landing is almost inevitable, as housing markets are grinding to a halt and consumer spending is fading
- The dot plot indicates 125bps of additional hikes in 2022 plus another 25bps in 2023 before cuts in 2024 and 2025

Treas.	Now	9.45AM	Chg.
3mo	3.26	3.29	-(0.03)
2yr	4.09	3.98	+0.11
5yr	3.82	3.75	+0.07
10yr	3.58	3.56	+0.02
30yr	3.55	3.57	-(0.02)
3m/2s	83	69	+14
2s/10s	(51)	(42)	-(9)
2s/30s	(54)	(42)	-(13)



Source: Bloomberg

The Federal Reserve Open Market Committee raised their target for overnight interest rates 0.75%, the third increase of that magnitude, and easily the fastest pace of hikes in any three-month period in four decades. Policy errors come in many forms. In 2007, the European Central Bank (ECB) tightened policy on the verge of severe recession. In 2018, the Federal Reserve hiked while the rest of the world was in easing mode, creating fractures in money market plumbing that contributed to the financial market mayhem in 2020. Today, while there is no denying that monetary policy is responsible for reducing forward-looking inflation, the extreme pace of these hikes risks invoking the old tech startup adage, “Move Fast and Break Stuff!” But the global economy is not a tech start up with a huge right tail and a high tolerance for failure, and there are early signs that stuff is indeed breaking. One need only look to the J.P. Morgan Emerging Market FX index, now trading at an all-time low, to guess what that breakage might be.

Domestically, economic data since the FOMC last met has been generally disappointing, both on the growth and the inflation front. While job gains have sustained at an impressive pace, consumer spending has begun to fade. Retail sales in the critical back-to-school period only matched inflation, while services spending has fallen below the rate of CPI inflation for two months now. Furthermore, the housing markets are doing their best impression of Wile E. Coyote. Even though interest rates have pushed housing affordability off the cliff, homebuilders have not yet looked down, and are instead supporting sales through mortgage rate buydowns, even while making plans to halt new construction. Core CPI inflation, meanwhile, has a stubborn streak, having printed +0.6% MoM in August despite early signs of slowing in the prior month’s data. On inflation, Fed policy is largely responding to heavily lagged data, but the dynamics of underlying inflation are too complex to have any confidence that it will slow rapidly—with or without policy input. In short, the data are deteriorating and the outlook is no better.

The FOMC statement had, for the third time in a row, few changes. One interpretation is that conditions are uncertain, and little changed themselves, so the committee has little to add. Another is that the Fed wants to inject uncertainty as to the future path of short-term rates and is doing so by limiting the information they convey. In today’s statement, the FOMC upgraded overall activity to “modest growth” from “have softened.” Most importantly, there is no signal that policy is anywhere near a pause.

The Fed also published its updated participant economic and rate forecasts, and there is little reason for optimism there either. Fed participants reduced (median) expectations of GDP growth in 2023 by 0.5%, upped unemployment by 0.5%, and increased core inflation by 0.4% as compared to the June forecasts. Policymakers are essentially predicting an inflationary recession. In addition, new forecasts for overnight rates now have 125-basis-point rate hikes in 2022 and another 25 basis points in 2023. In other words, the median of Fed official forecasts has the Fed hiking into (or at least not cutting into) a recession. That is a gnarly situation.

Immediate market response to the FOMC statement was messy. Short-term interest rates spiked, while long-term interest rates remained flat, leading to a violent flattening in the yield curve. Risk assets fell sharply—the S&P 500 fell -1% vs. pre-release levels, and the dollar spiked. That latter move may prove to be the most dangerous. At extremes, the U.S. dollar acts as a wrecking ball.

FEDERAL RESERVE press release

• There is now "modest growth in spending and production" whereas prior language referenced slowing growth

• No other changes elsewhere in the statement

• Voting was again unanimous

Recent indicators point to modest growth in spending and production. Job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher food and energy prices, and broader price pressures.

Russia's war against Ukraine is causing tremendous human and economic hardship. The war and related events are creating additional upward pressure on inflation and are weighing on global economic activity. The Committee is highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 3 to 3-1/4 percent and anticipates that ongoing increases in the target range will be appropriate. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet that were issued in May. The Committee is strongly committed to returning inflation to its 2 percent objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michael S. Barr; Michelle W. Bowman; Lael Brainard; James Bullard; Susan M. Collins; Lisa D. Cook; Esther L. George; Philip N. Jefferson; Loretta J. Mester; and Christopher J. Waller.

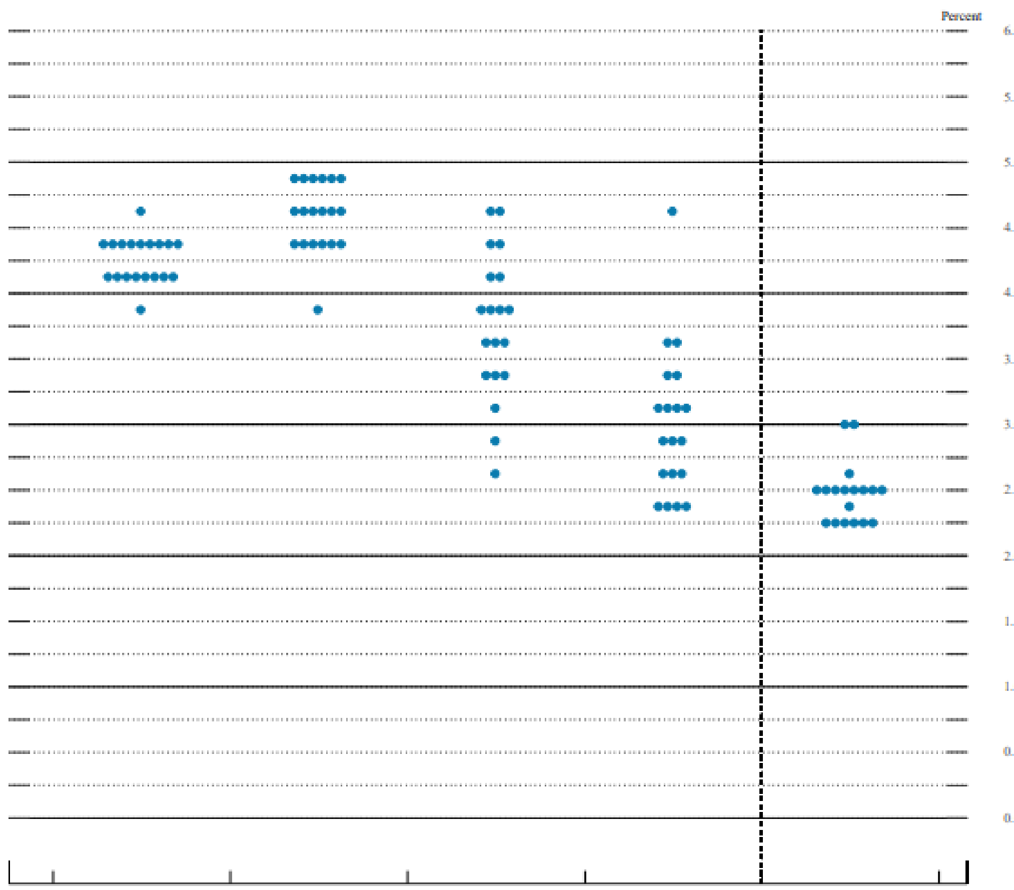
• Economic projections include slower growth and higher inflation for 2023—this is as close to recession as these estimates get

• The dot plot has a median of 4.375% rates for 2022, implying 125bps of additional hikes, fully 50bps more than markets anticipated

• The Sept. dots include 2025 projections for the first time; those projections have short-term rates significantly lower

Percent

Variable	Median[1]					Central Tendency[2]					Range[3]				
	2022	2023	2024	2025	Longer run	2022	2023	2024	2025	Longer run	2022	2023	2024	2025	Longer run
Change in real GDP	0.2	1.2	1.7	1.8	1.8	0.1–0.3	0.5–1.5	1.4–2.0	1.6–2.0	1.7–2.0	0.0–0.5	-0.3–1.9	1.0–2.6	1.4–2.4	1.6–2.2
June projection	1.7	1.7	1.9		1.8	1.5–1.9	1.3–2.0	1.5–2.0		1.8–2.0	1.0–2.0	0.8–2.5	1.0–2.2		1.6–2.2
Unemployment rate	3.8	4.4	4.4	4.3	4.0	3.8–3.9	4.1–4.5	4.0–4.6	4.0–4.5	3.8–4.3	3.7–4.0	3.7–5.0	3.7–4.7	3.7–4.6	3.5–4.5
June projection	3.7	3.9	4.1		4.0	3.6–3.8	3.8–4.1	3.9–4.1		3.5–4.2	3.2–4.0	3.2–4.5	3.2–4.3		3.5–4.3
PCE inflation	5.4	2.8	2.3	2.0	2.0	5.3–5.7	2.6–3.5	2.1–2.6	2.0–2.2	2.0	5.0–6.2	2.4–4.1	2.0–3.0	2.0–2.5	2.0
June projection	5.2	2.6	2.2		2.0	5.0–5.3	2.4–3.0	2.0–2.5		2.0	4.8–6.2	2.3–4.0	2.0–3.0		2.0
Core PCE inflation[4]	4.5	3.1	2.3	2.1		4.4–4.6	3.0–3.4	2.2–2.5	2.0–2.2		4.3–4.8	2.8–3.5	2.0–2.8	2.0–2.5	
June projection	4.3	2.7	2.3			4.2–4.5	2.5–3.2	2.1–2.5			4.1–5.0	2.5–3.5	2.0–2.8		
Memo: Projected appropriate policy path															
Federal funds rate	4.4	4.6	3.9	2.9	2.5	4.1–4.4	4.4–4.9	3.4–4.4	2.4–3.4	2.3–2.5	3.9–4.6	3.9–4.9	2.6–4.6	2.4–4.6	2.3–3.0
June projection	3.4	3.8	3.4		2.5	3.1–3.6	3.6–4.1	2.9–3.6		2.3–2.5	3.1–3.9	2.9–4.4	2.1–4.1		2.0–3.0



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