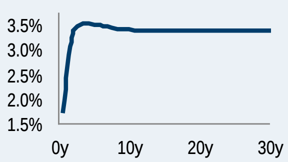
June 15, 2022

FED MOVES TO RED ALERT

- The Federal Reserve raised overnight interest rates 75 basis points to a range of 1.50–1.75%, the first hike of that magnitude since 1994
- Make no mistake: This is a hawkish 75bps hike, with Powell likely to emphasize ability to go even faster if needed
- The path of rate hikes appears to be steepening, with 300bps more priced in before cycle end, easily enough to trigger a recession
- Dot plot has federal funds rate peaking at 3.75% in 2023 before rate cuts emerge in 2024, presumably in the face of an economic recession

Treas.	Now	1.45PM	Chg.
3mo	1.77	1.74	+0.03
2yr	3.40	3.34	+0.05
5yr	3.53	3.51	+0.02
10yr	3.42	3.41	+0.01
30yr	3.40	3.41	-(0.01)
3m/2s	162	160	+2
2s/10s	3	7	-(4)
2s/30s	1	7	-(6)



Source: Bloomberg

The first rate hike of this cycle in March feels awfully far away. After starting moderately, the FOMC today elected to execute the largest rate hike in more than a quarter century on the backs of rising consumer inflation expectations. While we anticipated a 50bps increase in rates heading into this week, the Fed leaked a planned 75bps and today made good on those plans. Interest rate increases of this margin will sharply slow financing-sensitive sectors of the economy (housing and autos), drastically increasing the probability of recession. The complicated part comes if inflation remains high into the early part of any downturn, which will limit the Fed's ability to respond to slowing conditions and extend a brief recession to a much longer one.

Once again, economic data since the FOMC last met has been mixed on growth and problematic on inflation, the third time this year we've issued that comment. Job gains, while contracting in some high-flying sectors, remain solid economy wide. Consumer spending is leading towards another hot summer, with outlays on services notably elevated, but outlays on goods fading. Given that consumer incomes are negative on a real basis, these services outlays are coming at the expense of accumulated savings. When the consumer starts running low on savings, the strongest pillar of the economy faces risks while housing markets—hindered by higher interest rates—are about to contract. In the meantime, those services outlays are keeping price pressures high. Core CPI inflation printed +6.1% 3-month annualized pace in May, and while those figures should slow, they may end up at an uncomfortably high level. The bigger worry for Powell seems to be the New York Fed's Survey of Consumer Inflation Expectations, which drifted higher in June, despite the Fed's efforts to quell price fears. In a few scant months, we've gone from a Fed expressing concern to one on red alert seeking the most aggressive rate hikes in a generation to fight an enemy that arrived with the worst possible timing.

The FOMC statement had relatively few changes. Economic comments in the FOMC commentary were a bit surprising in light of recent growth data, as policymakers noted "activity appears to have picked up." It seems the FOMC also reduced perceived uncertainty of the Ukraine conflict with a little subtle wordsmithing. Finally, the Fed reinforced its inflation-fighting language, noting that it is "strongly committed" to reducing inflation, signaling possibly further hawkish optionality.

In addition to the policy announcement, the Fed also published its updated participant economic and rate forecasts. Predictably, those forecasts included some downside employment forecasts, as well as increased rate-hike forecasts—the median projection now calls for a further 1.50–1.75% increase in overnight rates this year, as well as rate cuts by 2024. In other words, the median Fed official's forecast implies rate cuts into a recession.

Since the Fed starting hiking in March until today's announcement, 10-year yields were up +125bps and mortgage rates +165bps, while the S&P 500 was down -11%. That's a lot of policy tightening already. In the immediate aftermath of the FOMC statement release, short-term rates were higher, while longer-term rates were roughly unchanged, leaving the curve flatter (2s/10s is a mere +3bps wide). Equity markets were slightly higher following the release, but the difference is well within the range of noise. That noise, however, sounds like a warning klaxon.

FEDERAL RESERVE press release

• Fed curiously upgrades economic activity slightly

Overall economic activity appears to have picked up after edging down in the first quarter. 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 energy prices, and broader price pressures.

The invasion of Ukraine by Russia is causing tremendous human and economic hardship. The invasion and related events are creating additional upward pressure on inflation and are weighing on global economic activity. In addition, COVID-related lockdowns in China are likely to exacerbate supply chain disruptions. The Committee is highly attentive to inflation risks.

• Now "strongly committed" to fighting inflation

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 1-1/2 to 1-3/4 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.

• We have two new Board Members, Philip Jefferson and Lisa Cook, eligible to vote at today's FOMC meeting; George opted for a 50bps hike

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; Michelle W. Bowman; Lael Brainard; James Bullard; Lisa D. Cook; Patrick Harker; Philip N. Jefferson; Loretta J. Mester; and Christopher J. Waller. Voting against this action was Esther L. George, who preferred at this meeting to raise the target range for the federal funds rate by 0.5 percentage point to 1-1/4 percent to 1-1/2 percent. Patrick Harker voted as an alternate member at this meeting.

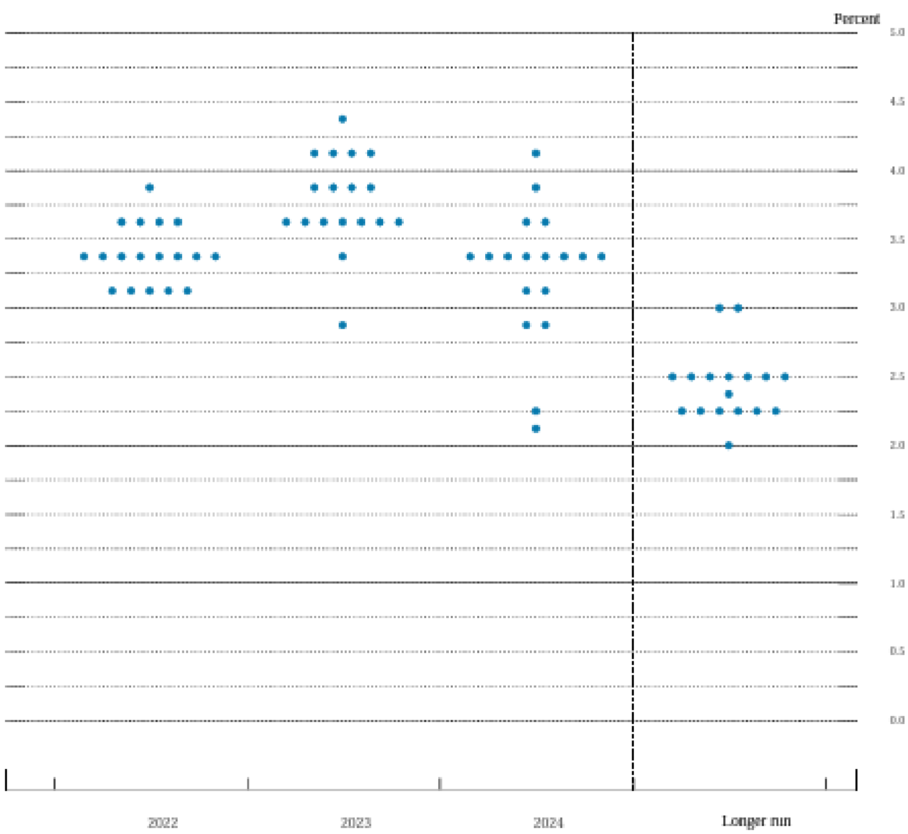
• Economic projections now include a slightly (optimistically) higher unemployment rate through 2023, but 2023's expected PCE inflation is lower than forecast in March

Percent

Variable	Median[1]				Central Tendency[2]				Range[3]			
	2022	2023	2024	Longer run	2022	2023	2024	Longer run	2022	2023	2024	Longer run
Change in real GDP	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
March projection	2.8	2.2	2.0	1.8	2.5–3.0	2.1–2.5	1.8–2.0	1.8–2.0	2.1–3.3	2.0–2.9	1.5–2.5	1.6–2.2
Unemployment rate	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
March projection	3.5	3.5	3.6	4.0	3.4–3.6	3.3–3.6	3.2–3.7	3.5–4.2	3.1–4.0	3.1–4.0	3.1–4.0	3.5–4.3
PCE inflation	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
March projection	4.3	2.7	2.3	2.0	4.1–4.7	2.3–3.0	2.1–2.4	2.0	3.7–5.5	2.2–3.5	2.0–3.0	2.0
Core PCE inflation[4]	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	
March projection	4.1	2.6	2.3		3.9–4.4	2.4–3.0	2.1–2.4		3.6–4.5	2.1–3.5	2.0–3.0	
Memo: Projected appropriate policy path												
Federal funds rate	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
March projection	1.9	2.8	2.8	2.4	1.6–2.4	2.4–3.1	2.4–3.4	2.3–2.5	1.4–3.1	2.1–3.6	2.1–3.6	2.0–3.0

• Dot plot does not include a median 3.375% rate by year end 2022, up 150bps from the prior projection

• Fed officials are projecting a peak FF rate of 3.75% in 2023 before rate cuts priced in 2024



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