The Federal Reserve Open Market Committee turned more aggressive in this month's meeting by raising the key fed funds interest rate by 0.50%—for the first time in over twenty years by that amount—to a new range of 0.75-1.00%. There were no dissents. This was in line with consensus estimates, steered by Fed member comments over the past few weeks that guided markets to anticipate this more hawkish outcome.

The formal statement language noted that economic activity edged down in Q1, although household and business spending remains strong, as are job gains. Inflation was described as remaining elevated, reflecting ongoing pandemic disruptions as well as higher energy prices, although broadened to other areas. Ukraine was also mentioned as an additional source of geopolitical uncertainty, and Covid lockdowns in China continuing to weigh on supply disruptions. In addition to today's rate hike, 'ongoing' rate increases were seen as appropriate. Guidelines for balance sheet reduction were also outlined, set to begin in June at $47.5 bil./mo., ramping up to $95 bil./mo. after three months.

Based on CME data, formal probabilities of a 0.50% fed funds hike ticked up a few percentage points in recent days to just under 100%[1]. In addition, a 0.75% rate increase is the highest expected outcome for June. The September level is predicted to reach 2.50-2.75% (around the Fed long-term neutral rate), and 3.00-3.25% by December, although that features more outcome dispersion on both sides. The latest period available, Jul. 2023, shows the highest probability being 3.50-3.75%, implying some slowing in the hiking pace by that time. Regardless, markets are predicting a much more aggressive Fed pace than we've been used to, although these probability markets are subject to rapid change.

The Fed's evaluation metrics remain mixed, in terms of high inflation being offset by still decent, but decelerating economic growth fundamentals:

<u>Economy</u>: Economic growth projections for Q1 had steadily fallen over the past several months, noted by the advance release of a contractionary -1.4% last week, which surprised many. This is as high commodity input prices, Ukraine, and Covid shutdowns again in China have combined to raise the possibility of a potential recession this year. However, Atlanta Fed's GDPNow, updated every few days, has crept back up to a moderate 2.2% rate for Q2. A recession still does not appear to be the base case for many economists, although the group tends to be mixed about 'soft landings' being possible along with interest rate increases, albeit difficult to achieve. Growth estimates for 2022 remain surprisingly robust, and above-average (2.5-3.5% or so) relative to pre-Covid trend (range of 2.0-2.5%). Consumers and businesses are not heavily indebted and speculative credit activity does not appear to be high relative to the ability to cover interest costs, which is not always the case when late cycle dynamics arrive and speculative financing is in high gear. This is one of the reasons for the low recession conviction, or, if an official recession does hit, it could be mild.

<u>Inflation</u>: The February CPI release noted 8.5% and 6.5% for trailing 12-month headline and core increases, respectively[2]. CPI continues to set multi-decade highs last seen in the early 1980s Paul Volcker era, which that Fed Chair fought with aggressive interest rate hikes—pushing the U.S. economy into a double-dip recession. It's debatable how viable such a policy would be today. While the Fed has received some negative feedback about being 'late' in tightening policy to fight inflation, much of the information at the time pointed to supply and transportation disruptions being transitory, with subsequent new Covid variants and the extreme Chinese lockdown policy response incrementally pushing out the timeline for deflating that inflation. Now, rising prices have had time to permeate more segments of the economy, including wages. How much inflation is the Fed willing to tolerate? And, how fast will it normalize?

<u>Employment</u>: The labor market remains the bright spot in the U.S. economy, with little room left for continued improvement. This continues to be true in almost all measures, from the unemployment rate to jobless claims, job openings, and level of quits. In fact, there are far more jobs than workers available, which has been blamed on everything from generous pandemic unemployment benefits, worker choosiness, immigration policies, wealth effect-based retirements, and some heavily-researched 'mystery' components. Regardless, this strength

may persist as long as the economy is in recovery mode, but could also fall back if the economy slows and the open jobs evaporate. One interesting metric is that the unemployment rate rising above that of the rate 12 months prior has been a classic indicator of potential recession.

With the Fed dedicated to a swift pace of monetary tightening, the remaining questions are how long and how much. The faster the rate hike movement happens, the greater the chance for a policy error-caused recession. If one looked at standard policy metrics, such as the 'Taylor Rule', developed by Stanford economist John Taylor as a reflection of output gap, inflation relative to target, etc., the fed funds rate 'should' be somewhere between 6-9%[3]. As the Fed believes inflation is at least still partially transitory, such a rate could be excessive, and may need to be reversed before reaching a higher target. There is also ongoing thinking that underlying economic growth in the economy and lack of imbalances, other than current high inflation, do not warrant a very high policy rate longer-term. These views will have to be rectified over the course of 2022 and 2023, if inflation conditions don't improve on their own by then.

So far this year, financial conditions overall have also helped to tighten policy, which include long-term interest rates (higher), stock prices (lower), credit spreads (wider), and relative strength of the U.S. dollar (higher, hurting exporters). A big question is: can or should the Fed be attacking inflation caused by non-monetary sources with monetary tools? It comes down perhaps to determining how much of the current inflation is due to Fed policy, and long-term accommodative policies, while the remainder is due to fiscal stimulus, and of course, supply constraints. It's not possible to break these out with precision, but M2 monetary supply growth has already been decelerating dramatically from its peak.

From an investment perspective, higher short-term interest rates raise the prospects for reserve assets such as cash, while they also serve as an anchor on the yield curve for long-term rates. However, long rates are more directly affected by long-term inflation and growth expectations (as well as anticipated and actual Fed drawdown of their immense balance sheet to a smaller or larger degree). On the bright side, shorter-duration bonds have fared better in rising rate environments, as expected, but bond markets overall reset with higher long-term return expectations due to the rising tide of yields. Of course, if long-term rates have peaked, which some believe, bonds may look attractive for price appreciation reasons. Equities have historically performed well in the sweet spot of moderate economic/earnings growth and contained inflation, but can struggle if inflation rises into the higher single-digits. (Stocks are already down -15% this year, which could be argued as already partially discounting this effect and/or rising probabilities of recession.) Interest rate spikes can disrupt equities as well in the short term, but stocks have tended to far positively in the year or two following the start of a hiking cycle (as those tend to go along with strong growth). As has been the case in the last few years, commodities have shown a strong 'beta' to inflation, not to mention geopolitical product disruptions, and have remained the stars of the recent period.

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Sources:
[1]CME Group (https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html)
[2]U.S. Bureau of Labor Statistics
[3]Federal Reserve Bank of Atlanta (https://www.atlantafed.org/cqer/research/taylor-rule)