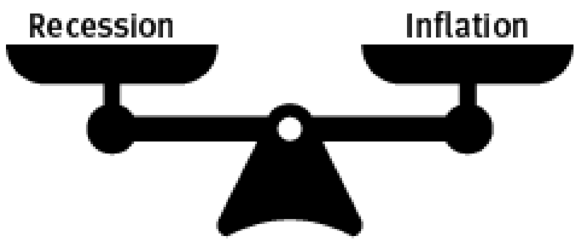
Economic **INSIGHT**

August 1, 2022

Federal Reserve to Potentially Soften Pathway as Recession Lurks

Last week, as expected, the Federal Reserve (Fed) opted to raise rates another 75 basis points (bps), taking the target range for the federal funds rate to 2.25-2.50%. Also as expected, the July Federal Open Market Committee (FOMC) statement indicated further increases would likely be appropriate. However, with inflation still too high and the economy beginning to show signs of waning momentum, what is the future pathway for policy? Will the Fed continue at this more aggressive pace to ensure a reduction in cost pressures, or will it downgrade the size of future rate hikes amid a rising risk of recession? Fed Chairman Jerome Powell attempted to strike a balance, suggesting incoming data will drive policy decisions meeting to meeting. The market, however, is betting on the Committee cracking in its resolve to bring down costs as domestic weakness becomes increasingly apparent.



POLICY ANNOUNCEMENT

Meeting market expectations, the Fed unanimously agreed to a 75-bps increase in the federal funds target range last week after raising rates a similar 75 bps in June. Since March, the Committee has increased the target by 225 bps to 2.50%, the highest level since August 2019.

Ahead of last week's rate decision, market participants had begun to consider a full one-percentage point increase following a larger-than-expected increase in the June CPI and PPI reports. With a growing expectation, however, that inflation may have peaked with a more recent retreat in commodity prices, coupled with some Fed officials voicing concerns of a *"super-sized"* rate hike, investors reduced forecasts from 100 bps back down to a second-round 75-bps rate hike. In other words, the policy announcement itself was uneventful to say the least.

In the July FOMC statement, the Committee maintained language suggesting *"ongoing increases in the target range will be appropriate."* The *size*, however, of additional rate hikes going forward is now the bigger question. When asked during the press conference about the potential for a 100 bps increase down the road, Powell was clear that the Committee *"would not hesitate"* to implement a 1% increase or larger if

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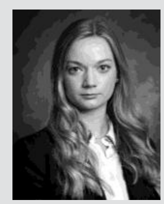

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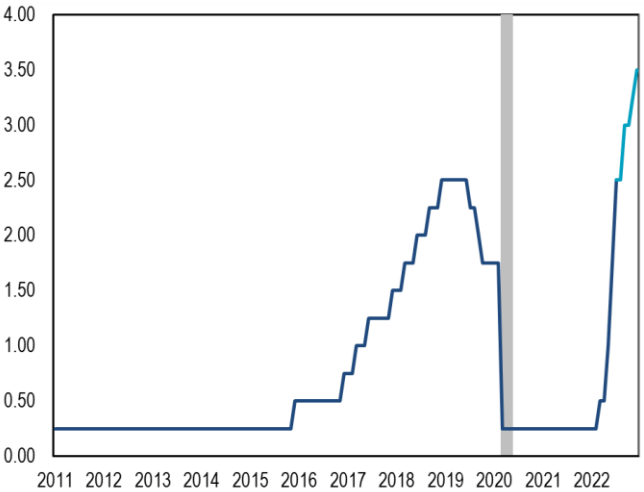
deemed appropriate based on the incoming data. For now, however, sending somewhat of a mixed message, Powell reiterated that the Committee felt a 75-bps hike was the *"appropriate"* move, as the full weight of earlier rate increases has likely not been felt and policy is likely at or nearing neutral.

YEAR-END TARGET

According to the Fed's latest Summary of Economic Projections (SEP), the majority of Committee members anticipate rates rising to 3.50% by year end. While this forecast is now six weeks old and produced before the latest, hotter-than-expected June inflation reports, Powell indicated it is still the best indication of policy makers' expectations for rates over the next five months. That being said, he emphasized the difficulty in forecasting monetary policy during the best of times, which given the unprecedented amount of uncertainty in the current environment, has become increasingly more difficult. Policy, he said, will be made on a meeting-to-meeting basis predicated on incoming data and *without* the benefit of more explicit guidance offered ahead of prior meetings.

Despite Powell's lack of specificity, market participants appear to be focusing in on the more dovish aspect of his comments. In fact, according to *Bloomberg*, investors are beginning to soften their outlook for additional rate increases, with a 50-bps hike in September fully priced in, followed by an expectation for two additional quarter-point hikes in November and December.



Source: Federal Reserve Board/Bloomberg *Median projections based on June Dot Plot

Of course, while such a proposal seems reasonable based on the Fed's earlier projections, the SEP will be updated eight weeks from now at the September 21 meeting. If inflation remains at these elevated levels between now and then, the Committee could materially increase its expectations for rates in the coming months. After all, given the Fed has indicated a marked reduction in inflation is a prerequisite for a more benign policy pathway, without a convincing retreat in the next two inflation reports, it's going to be difficult for the Fed to pivot away from its commitment to pulling down prices without 1) losing credibility in the market, and 2) potentially losing control of inflation expectations.

During the press conference, Powell indicated that they are trying not to make a mistake in either direction when repeatedly asked if the bigger risk for policy makers was doing too much or doing too little. He did note that they recognize there are two sides. Doing

GLOSSARY

FOMC: Federal Open Market Committee

GDP: Gross Domestic Product

SAAR: Seasonally Adjusted Average Rate

SEP: Summary of Economic Projections

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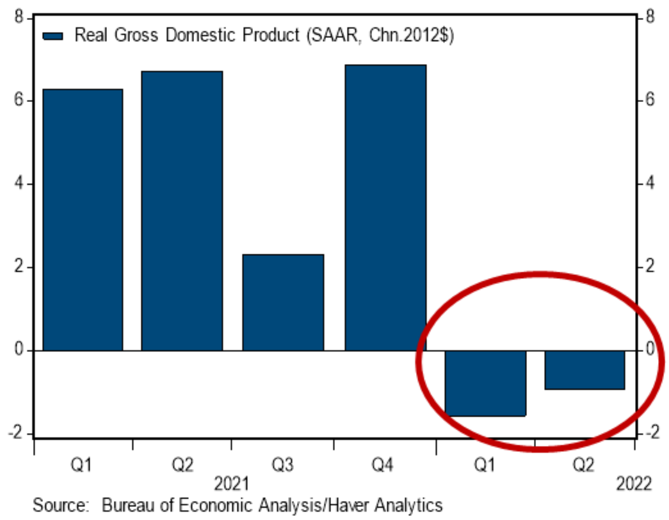
too much may impose more downward pressure on the economy than is necessary, however, doing too little and leaving cost pressures entrenched in the economy only leaves a larger cost of having to deal with lingering inflation later. In other words, doing more now ensures a more stable economy and allows for a stronger labor market over the longer run. It is *"essential,"* Powell said, to bring down *"too high"* inflation. Restoring price stability is something we *"must do."*

ECONOMIC WEAKNESS

Despite attempts to muster a hawkish stance or mirror the Fed's earlier war cry of "whatever it takes" against inflation, Powell's comments this week seemed to reinforce expectations for a slower pace of rate hikes and a softer level of growth. At this point, investors seem to be losing hope the Fed will be able to raise rates and tackle inflation while avoiding meaningful economic damage, producing the so-called soft landing.

Following the Fed's rate announcement, equities rose sharply with the Dow gaining 1.4%, the S&P 500 rising 2.6%, and Nasdaq jumping 4.1%. Longer-term yields, meanwhile, pushed lower with the 10-Year Treasury dropping 9 bps to a low of 2.72% before finishing the day at 2.79%.

According to the July FOMC statement, recent indicators of spending and production have "softened," although "job gains have been robust in recent months, and the unemployment rate has remained low." Powell was optimistic that household balance sheets are in "sound" condition, however, a period of slow growth, he said, is "necessary" to allow demand to cool and supply to play catchup. He further said that in all likelihood we will also see a softening of employment conditions. While a recession is not necessary, and the U.S. economy does not appear to currently be in recession with several sectors still faring well, additional weakness or a sustained period "below potential to create some slack" is likely to get inflation back down to the Fed's 2% target range.



Of course, the latest read on Q2 GDP reinforces Powell's assessment of weaker, but not plummeting growth. According to the Bureau of Economic Analysis, second-quarter GDP fell 0.9%. With a 1.0% rise in consumer spending, a good portion of the weakness centered in a lack of inventory management in this volatile environment, excluding inventories, growth actually rose 1.1% April to June. Of course, following a larger 1.6%

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decline at the start of the year, topline growth has been trending negative for two consecutive quarters, the threshold often used as the layman's gauge of recessionary conditions.

CONCLUSION

The Federal Reserve was arguably late to the inflation party, failing to drop the transitory language until late 2021 when inflation was already reaching new four-decade highs. Nevertheless, at this point, with four rate hikes and 225 bps of tightening already underway, the Fed may be forced to raise rates at a significantly more aggressive pace to rein in cost pressures than would have otherwise been needed had the Committee taken action sooner.

Of course, putting what the Fed should have done behind us, the question remains what will the Fed do now? Powell continues to toe the hawkish line of maintaining a focus on inflation, assuring the market that reinstating price stability is the Fed's primary goal. It "must be done" he asserted. However, his comments focusing on the emerging weakness in domestic activity, coupled with the lack of forward guidance has led many investors to question the Fed's resolve for a continued aggressive approach to policy. In other words, does the Fed have the stomach to keep raising rates with a recession lurking around the corner? The Fed says yes, the market says no. Who will flinch first?

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