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Overseas Volatility Leaves Fed on Aggressive Pathway with Eyes Wide Open

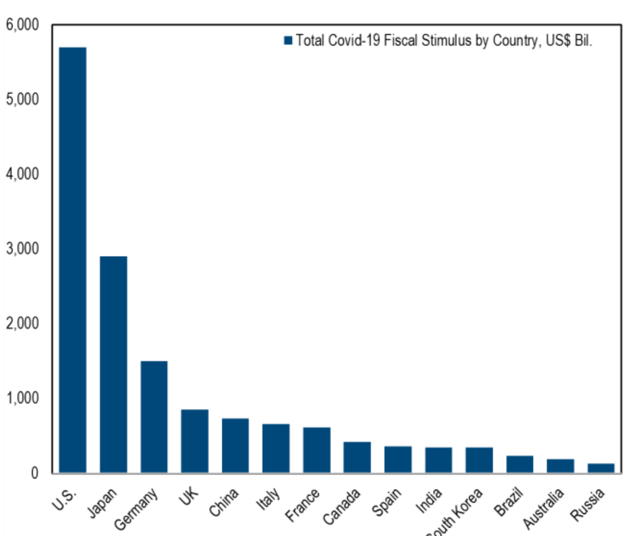
Economic INSIGHT

Elevated prices amid slowing growth is currently a shared condition among developed countries, but while central banks have moved to higher rate policies in an attempt to reinstate price stability, the reaction from fiscal policy leaders and market participants has varied dramatically from country to country.

UK markets, for example, were roiled when UK Prime Minister Liz Truss announced tax-cutting initiatives that could compound inflationary pressures already at four-decade highs. While officials were quick to note the unpredictability in U.S. markets as well, the volatility abroad is a harsh reminder of how quickly conditions can change and deteriorate with economic activity increasingly fragile.

LESSON LEARNED

At the onset of the COVID-19 crisis and amid crumbling economic conditions, leaders around the developed world struggled to provide support to their economies. In the U.S., officials spent roughly $6 trillion, which was more than double the next highest spender, with much of the expenditures in the form of direct payments. While arguably necessary, such massive growth in fiscal outlays has exacerbated the current inflationary conditions.



Source: Vivid Economics

While other developed countries around the globe contend with higher inflation rates relative to the pre-pandemic world, prices are higher in the U.S. than almost anywhere else in the world. Globally, countries are collectively reeling from supply-side constraints, but in the U.S., inflationary conditions were further fueled by rising demand and labor costs resulting from

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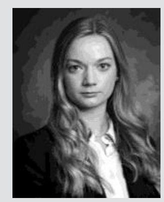

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the influx of unprecedented fiscal dollars, a lesson the U.K. government may be well advised but unlikely to heed.

In office for less than a month, newly minted Prime Minister (PM) Liz Truss unveiled a series of budget initiatives including sizable tax cuts for individuals, including home purchasers specifically, and businesses. The "*mini-budget*" also calls for subsidizing energy costs by capping monthly expenditures so that a typical household in the UK will pay, on average, around £2,500 a year on their energy bill over the next two years starting October 1, 2022. While such measures will likely exacerbate the government's deficit by reducing government revenues by up to a reported £45 billion over the next five years, the Truss administration has been adamant further fiscal support is necessary to assist those facing ongoing hardship, particularly as energy costs and broader-based inflation rise. Treasury minister Andrew Griffith defended the government's plans, telling Sky News, "*We think they are the right plans because those plans make our economy competitive*."

Despite the best of intentions, many fear the Truss administration's initiatives will lead to the additional price pressures as seen in the U.S. In fact, in a rare reproach of specific sovereign policy, the International Monetary Fund was among those quick to criticize the UK government's latest call for further fiscal initiatives, urging PM Liz Truss to "*re-evaluate*" the proposed tax cuts, and warning measures such as these are likely to compound the inflationary battle of the country – and the world – and further complicate the Bank of England's ability to reinstate price stability. The latest read on prices shows UK inflation already rising nearly 10% last month – overtaking the U.S. in April of this year at 9.0% – with projections showing it could more than double by 2023.

MARKET REACTION

Reacting to proposed tax cuts and spending initiatives, against the backdrop of a decisively more hawkish Federal Reserve (Fed) raising rates 75 basis points (bps) for the third time in four months, UK markets responded with alarm. The British pound dropped 21% since the start of the year, reaching a record low on September 26. Yields, meanwhile, were on track for their sharpest rise in decades with the 10-year gilt yield jumping 170 bps since the start of the month from 2.88% to a high of 4.58% on September 28.

With market turmoil raging, earlier this week, the Bank of England (BOE) announced plans to buy long-dated gilts and delay planned sales of debt in an effort to stabilize the market. According to a statement released on Wednesday, the BOE will carry out temporary purchases, citing "*a material risk*" to financial stability that would lead to "*an unwarranted tightening of financing conditions and a reduction of the flow of credit to the real economy*."

GLOSSARY

YoY – Year over Year

BOE – Bank of England

FOMC – Federal Open Market Committee

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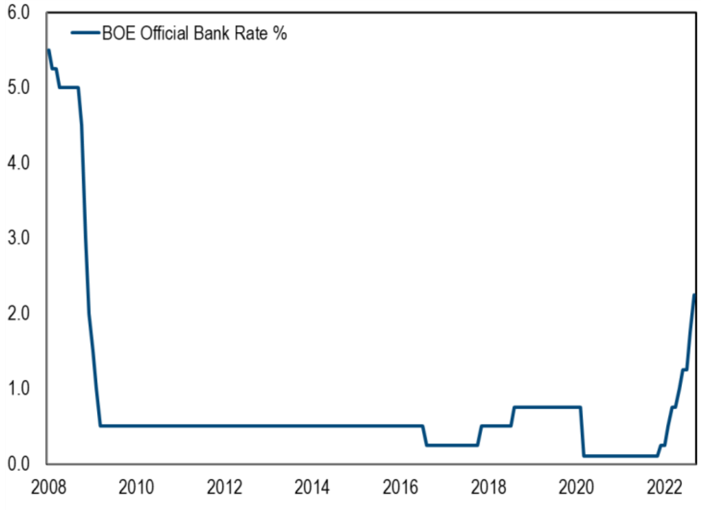
The latest policy announcement provided welcomed relief with the pound spiking on Wednesday and the yield on 30-year gilt plummeting more than 100 bps to 3.88%. By the end of the week, investors' concerns of rising inflation, while still elevated, appear somewhat subdued thanks to the – temporary – calm imparted from the BOE's action. Longer-term gilt yields closed at 3.82%, with the pound rising from the record low reached earlier in the week to $1.12.



Source: Bloomberg

Similar to the Fed, the BOE is moving along an increasingly aggressive rate path to tamp down prices. Announced just one day after the Fed's September Federal Open Market Committee meeting, the BOE increased rates by 50 bps to take its key lending rate to 2.25%, the highest level since 2008. While policy makers have indicated further policy tightening is necessary, expansive fiscal policy, coupled with a growing unease for unfavorable market reactions and an apparent willingness to intervene, the BOE is now imposing *conflicting* policy initiatives and assuming what appears to be an underdog position against price pressures.

FED REACTION MINIMAL

Back in the U.S., policy makers continue to maintain a hyper-focus on rising cost pressures in the domestic market. While aware of the contagion effect a further tightening at home will have on markets abroad, overseas volatility should not and will not be enough to deter the Committee from a more aggressive pathway given the still too-high level of prices.

While the focus of the markets, *at the moment*, is the unruly action in the UK, the recent volatility appears on par with the preceding wayward action in the U.S. market place. Since August, the 10-year gilt has risen 228 bps, while the yield on the 10-year Treasury has spiked more than 110 bps over the same timeframe. In other words, the growing and increasingly apparent "*dysfunction*" in the overseas market is in good part simply the 'volatility du jour,' or the latest reaction demanding investors' attention.

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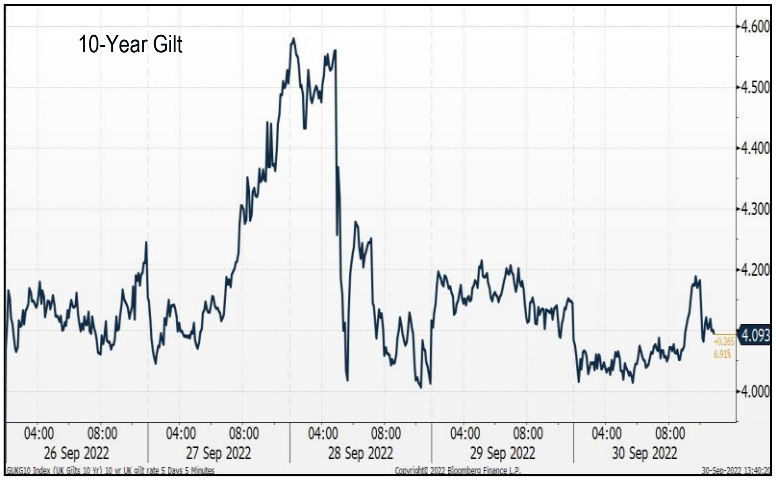

Such a violent reaction, however, is neither unexpected nor likely to end any time soon. After all, anticipating a smooth and orderly reaction from global investors in response to significantly tighter monetary policy in the aftermath of a 40% increase in the money supply since the start of 2020 and record-low rates is akin to expecting to avoid a sugar-fueled tantrum after leaving a toddler alone in a candy store for days and now demanding they eat nothing but broccoli.

CONCLUSION

While the consequences of unprecedented policy intervention have and will continue to vary country to country, the latest unfavorable market turmoil in the UK should be a good reminder to U.S. policy makers and investors alike how quickly conditions can change. Should sentiment shift, be that as a result of more expansionary fiscal policy – particularly in the aftermath of the November elections – or a perceived cracking in monetary policy officials' resolve to stay the course to tame inflation regardless of deteriorating domestic conditions, the U.S. market could have an equally violent reaction or rapid reversal in momentum.

At this point, as the Fed continues to raise rates nearer 4.5%, the short end of the yield curve will presumably follow along with monetary policy. The longer end, however, will struggle to keep up with the Fed as policy intentionally slows activity into, or further into, recession. Even with the marked backup in rates over the past eight weeks, the upward trajectory has not been enough to reinstate a more normal shape to the curve with the 2-year/10-year Treasury yield inversion (meaning the yield on the 2-year is higher than the yield on the 10-year) near the widest in more than 20 years at 35 bps. Thus, while the rising trend will likely be maintained near term, not only will curve inversion expectedly persist, but also once the market perceives a reduced conviction by Fed officials to move rates higher, the U.S. economy falls undeniably into recessionary territory or inflation recedes markedly, the tide is likely to reverse, and with gusto.

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