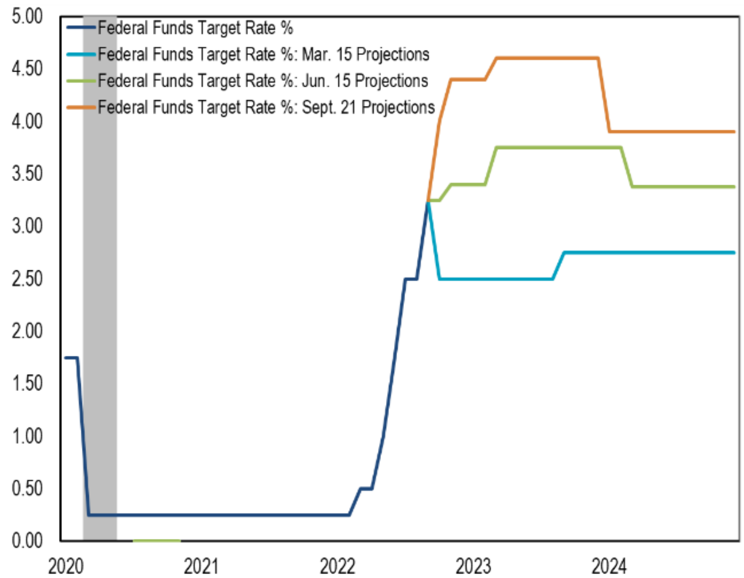
Economic INSIGHT

October 24, 2022

# Stubbornly Elevated Prices Likely to Further Federal Reserve Action



Source: Federal Reserve Board/Bloomberg

With inflation broadly and stubbornly elevated and core prices pushing to a fresh cycle peak in September, the Federal Reserve (Fed) has highlighted an ongoing and increased willingness to raise rates beyond earlier forecasts. In fact, the Fed has been increasingly clear it is willing to raise rates well into restrictive territory even at the risk of *further* undermining the domestic economy, or having a limited, additional impact on prices given the supply-side nature of cost pressures. As such, after already significantly raising the forecast for the terminal federal funds rate nearly 200 basis points (bps) from the initial March outlook, the Fed will likely continue to revise higher expectations for rates given improvement in price pressures has woefully underperformed expectations. The latest September Summary of Economic Projections (SEP) implies a federal funds rate of 4.4% by year end and 4.6% sometime in 2023. Such an outlook, however, is predicated on the expectation that inflation will decline meaningfully to 2.8% next year, an arguably overly optimistic target to say the least.

As the Fed continues to target higher rates, the short end of the yield curve will presumably move along with the Fed and further policy adjustments. The longer end of the yield curve, however, while likely to continue an upward ascent near term, will struggle to keep up with additional Fed rate hikes as policy intentionally slows the economy into or further into recession, beyond the "*period of pain*" the Fed has projected. Recall, even after a marked increase in the 10-year Treasury yield up 150 bps from a recent low of 2.58% in August, longer rates have not been able to overtake short-term rates with the 2/10 Treasury spread (the difference between the 2-year Treasury yield and the 10-year Treasury yield) widening to 43 bps as of October 19. Thus, inversion is likely to persist along the term structure for an extended period of time,

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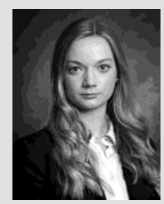

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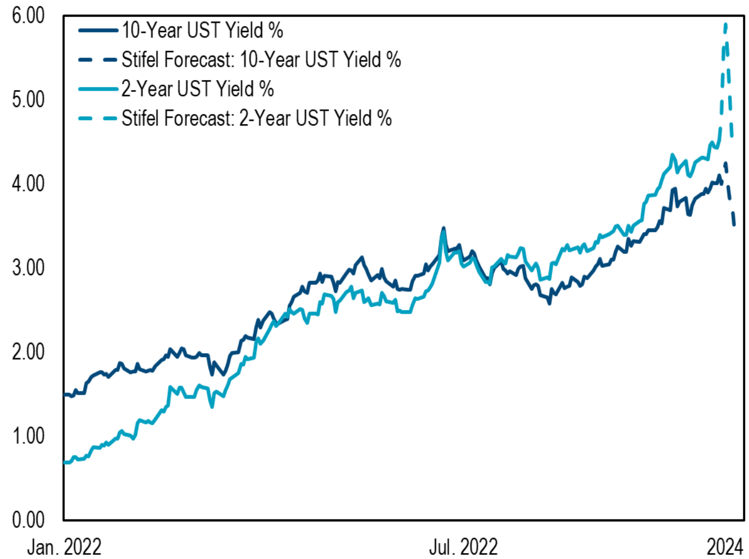
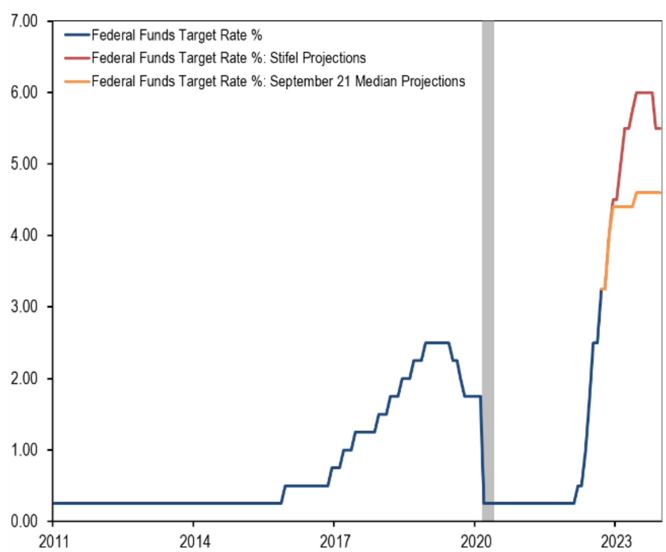
complicating the environment for financial institutions as well as the Fed still struggling to reach the desired level of policy needed to tame prices while avoiding a deep and prolonged decline in domestic activity.



Source: Bloomberg/Stifel

Eventually, downward momentum in longer-term rates will presumably return once the Fed has reached the terminal level, or is seemingly nearing a point where at least further rate increases are no longer necessary. Either scenario, however, must be accompanied by a *realized* reduction in inflation back toward the Fed's preferred 2% area. Beware, however, a meaningful retreat in (demand-side) cost pressures as the economy presumably slows further could prompt the market – or the Fed – to prematurely call a tipping point in policy. If the Fed backs off before the inflation dragon has been slain, the result could be an even more detrimental environment of stagflation whereby GDP remains below potential, coupled with inflation still notably above the longer-term sustainable rate.

Of course, ample risks – upside and downside – to the outlook remain. Should inflation remain elevated or push higher still as a result of ongoing trade disruptions or international conflict, or a resurgence of domestic demand and labor market pressures, the Fed will expectedly be willing to raise rates even higher than projected despite the declining marginal impact a further back up in borrowing costs will have on supply-side cost pressures and the rising risk to domestic growth. Alternatively, should inflation improve more rapidly than



Source: Federal Reserve Board/Bloomberg

**GLOSSARY**

YoY – Year over Year

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expected as a result of appeasement overseas or other factors, the Fed would presumably be equally willing to pull back on the projected pathway to higher rates sooner than expected.

At this point, the only certainty is uncertainty. Volatility as well as rapid and violent market reactions are likely to continue, with a single data point increasingly influential on sentiment and expectations.

| | June SEP | | | September SEP | |
|---|---|---|---|---|---|
| | 2022 | 2023 | | 2022 | 2023 |
| FF Rate: | 3.4% | 3.8% | FF Rate: | 4.4% | 4.6% |
| GDP: | 1.7% | 1.7% | GDP: | 0.2% | 1.2% |
| PCE: | 5.2% | 2.6% | PCE: | 5.4% | 2.8% |
| U6 Rate: | 3.7% | 3.9% | U6 Rate: | 3.8% | 4.4% |

Source: Federal Reserve


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## ECONOMIC FORECAST

| | | | | | | | | | | Annual Rate | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q2 2022 | Q3 2022 | Q4 2022 | Q1 2023 | Q2 2023 | Q3 2023 | Q4 2023 | Q1 2024 | Q2 2024 | 2022 | 2023 | 2024 |
| ***Growth indicators*** | | | | | | | | | | | | |
| **GDP, QoQ %** | ***-0.6%*** | **1.1%** | **-2.1%** | **-0.8%** | **-1.7%** | **0.3%** | **-0.9%** | 1.4% | 1.8% | **-0.8%** | **-0.8%** | **1.6%** |
| Consumer Spending, % | *2.0%* | 1.8% | -1.1% | -0.8% | 0.1% | 1.5% | 1.2% | 1.5% | 1.6% | 1.0% | 0.5% | 1.6% |
| Fixed Investment, % | *-5.0%* | 0.7% | -0.5% | -2.5% | -1.3% | -0.8% | 0.0% | 0.5% | 0.8% | 0.0% | -1.1% | 0.7% |
| Housing Starts, k, end of quarter, yr end | *1,559* | 1,500 | 1,480 | 1,425 | 1,400 | 1,475 | 1,525 | 1,585 | 1,630 | 1,480 | 1,525 | 1,630 |
| **Unemployment Rate, %, qrt avg, yr end** | *3.6%* | *3.5%* | 4.4% | 4.8% | 5.2% | 5.8% | 5.8% | 5.7% | 5.7% | 4.4% | 5.8% | 5.7% |
| Nonfarm Payrolls, k, qrt avg, ann avg | ***293*** | ***263*** | **150** | **-100** | **-250** | **-50** | **100** | **150** | **150** | **276** | **-75** | **150** |
| ***Inflation indicators, YoY%, yr end*** | | | | | | | | | | | | |
| PCE | *6.8%* | 6.5% | 6.4% | 5.8% | 5.5% | 4.5% | 3.8% | 3.5% | 3.2% | 6.4% | 3.8% | 3.2% |
| Core PCE | *4.8%* | 5.2% | 5.0% | 4.8% | 4.5% | 3.8% | 3.5% | 3.2% | 3.2% | 5.0% | 3.5% | 3.2% |
| PPI | *11.3%* | 9.6% | 8.8% | 7.2% | 6.5% | 6.0% | 4.8% | 3.9% | 3.2% | 8.8% | 4.8% | 3.2% |
| ***Interest rate, %, end of quarter, yr end*** | | | | | | | | | | | | |
| **FF** | ***1.75*** | ***3.25*** | **4.50** | **5.50** | **6.00** | **6.00** | **5.50** | **5.00** | **5.00** | **4.50** | **5.50** | **5.00** |
| 3month UST bills | *1.67* | *3.27* | 4.45 | 5.45 | 6.00 | 5.95 | 5.40 | 4.95 | 4.90 | 4.45 | 5.40 | 4.90 |
| 2yr UST notes | *2.96* | *4.28* | 4.80 | 5.60 | 5.90 | 5.50 | 5.00 | 4.50 | 4.50 | 4.80 | 5.00 | 4.50 |
| 5yr UST notes | *3.04* | *4.09* | 4.45 | 5.25 | 5.00 | 4.75 | 4.50 | 4.25 | 4.15 | 4.45 | 4.50 | 4.15 |
| **10yr UST notes** | ***3.02*** | ***3.83*** | **4.00** | **4.15** | **4.25** | **4.00** | **3.80** | **3.75** | **3.50** | **4.00** | **3.80** | **3.50** |
| 30yr UST bonds | *3.19* | *3.78* | 3.85 | 3.90 | 4.05 | 3.85 | 3.70 | 3.65 | 3.40 | 3.85 | 3.70 | 3.40 |
| **3mon to 2s spread bps** | ***129*** | ***101*** | **35** | **15** | **-10** | **-45** | **-40** | **-45** | **-40** | **35** | **-40** | **-40** |
| **3mon to 10s Spread bps** | ***135*** | ***56*** | **-45** | **-130** | **-175** | **-195** | **-160** | **-120** | **-140** | **-45** | **-160** | **-140** |
| **2s to 10s Spread bps** | ***6*** | ***-45*** | **-80** | **-145** | **-165** | **-150** | **-120** | **-75** | **-100** | **-80** | **-120** | **-100** |

Actual data in red (Source: Bloomberg) | GDP figures shown as annual change

## DISCLAIMER