September 23, 2022

MARKET SIGHTLINES

Federal Open Market Committee Update: Higher Rates for Longer

By Michael O'Keeffe, *Chief Investment Officer*

In No Cooling Trend for Inflation, we reviewed the August inflation reports that showed headline inflation as reasonable, anchored in falling energy prices over the month. Both the core consumer price index (core CPI) and core producer price index (core PPI) for August reflected sustained elevated inflation. So, everyone watched this week's Federal Reserve (Fed) meeting results with some anticipation, with almost everyone expecting our central bank to continue its hawkish policy shift to continue its battle to reign in higher inflation. The inflation report and the Fed meeting were key events we identified in Navigating the Rest of 2022: Get Ready for More Volatility, and that update included many other key dates to watch through the balance of the year. In this week's Sight|Lines, we review the results of the Fed meeting, some implications for future inflation, and market reaction.

THE FED CONTINUES ITS INFLATION FIGHT

Even prior to this week's meeting, the Fed has been communicating its intention to be aggressive with the goal of bringing inflation toward its 2% target. At the Jackson Hole symposium on August 26, Fed Chair Jerome Powell reiterated that "restoring price stability will likely require maintaining a restrictive policy stance for some time" and another "unusually large" increase in the federal funds rate could be appropriate in September. So, the Fed's unanimous decision to raise the benchmark rate 0.75% to a target range of 3.00%-3.25% was expected.

Notably, the Fed's statement was little changed from July, with the only adjustment being to describe "spending and production" as experiencing "modest growth" rather than "having softened." Otherwise, the action, a 0.75% rate hike, and the reason, the need to fight higher inflation, were unchanged. This consistency from one Fed statement to the next is unusual.

In his press conference after the meeting, Chair Powell took the opportunity to reinforce the Fed's inflation-fighting message. He said that the committee anticipates "ongoing increases in the target range for the federal funds rate will be appropriate" and they'll be "looking for compelling evidence that inflation is moving down, consistent with inflation returning to 2%."

Through the balance of the press event, Chair Powell observed that employment remained tight, the August inflation results were "higher than expected," and "notwithstanding the recent slowdown in overall economic activity, aggregate demand appears to remain strong, supply constraints have been larger and longer lasting than anticipated, and price pressures are evident across a broad range of goods and services."

The Fed felt justified in its rate hike decision.

THE SUMMARY OF ECONOMIC PROJECTIONS

The Fed shared its latest Summary of Economic Projections (SEP) after this week's meeting (see Figure 1). The projection trends starting with the December 2021 SEP continued with this release. The Fed once again raised its 2022 inflation forecast, this time to 5.4%, up from the 5.2% rate projected in June. Fed members signaled more rate hikes, with the year-end fed funds forecast rising to 4.4%, up a full 1% from the June SEP projection of 3.4%. And, with higher rates slowing the economy, the Fed lowered further its 2022 and 2023 GDP growth forecasts to 0.2% and 1.2%, respectively, a decline from the expected 1.7% growth rate forecast in the June SEP for both calendar years.

The progression of SEP forecasts illustrates that the Fed has underestimated the influence of continued supply shocks on inflation throughout the year, and officials have been ratcheting up the hawkish policy shift in response. This continued shift is slowing the economy, and forecasts imply the prospect of a "soft-ish" landing at best. At Jackson Hole, Powell acknowledged that that higher interest rates will "bring some pain to households and businesses," but a "failure to restore price stability would mean far greater pain."

MARKET RESPONSE

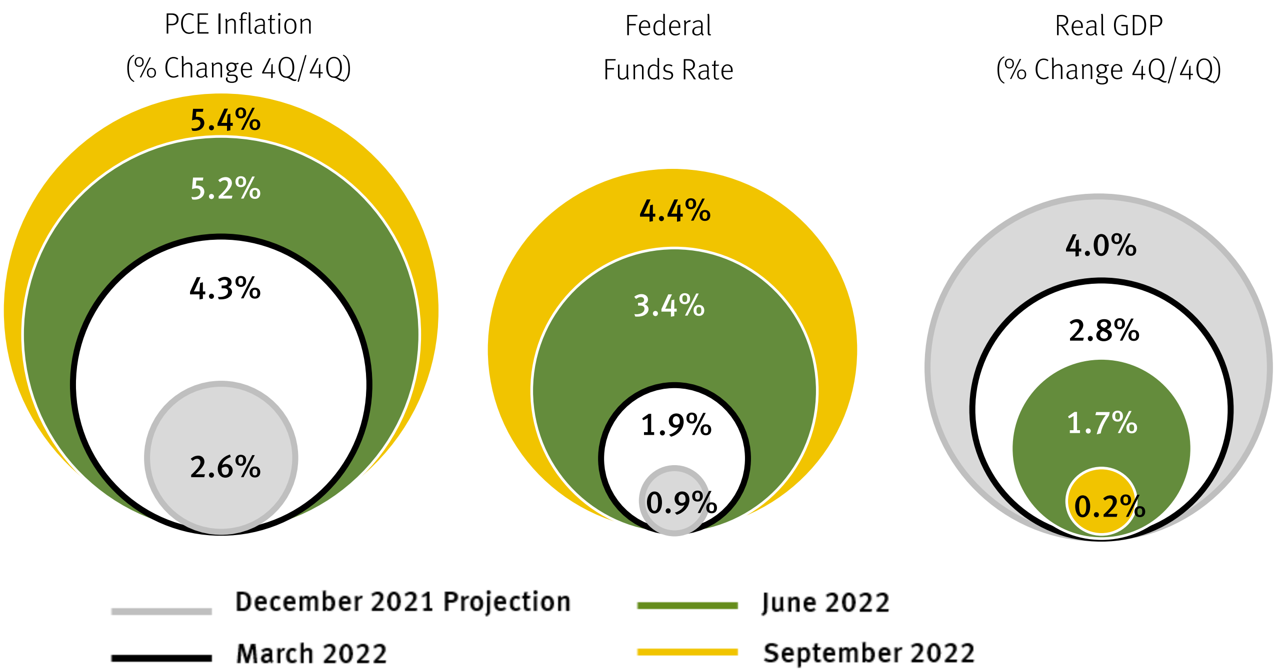
Investors and other market participants typically unpack the Fed policy decision, the corresponding statement, and the learnings of Chair Powell's press conference to discern how the market might react. And while the initial response on Wednesday was modestly positive, later in the trading day, stocks fell and closed lower, with the S&P 500 down 1.7% for the day. But the real story goes back a few weeks. The S&P 500 hit a 2022 low on June 16, really in response to the May inflation report and the Fed's June policy decision. But with hopes of cooling inflation and the prospect of the Fed slowing its policy shift, markets moved higher, with the S&P 500 coming to a local high on August 16. But since Powell's speech at Jackson Hole, the S&P 500 has trended lower and is now trading near the June lows.

CONCLUSION

In Navigating the Rest of 2022: Get Ready for More Volatility, we shared key dates to monitor to help us understand market dynamics for the balance of this year. This week we saw Fed meeting results, with the central bank reinforcing its concern about higher inflation, its hawkish policy shift to help, and its worsening SEP projections. While the market was volatile, as usual, on the day of the September decision, market weakness really started in August following the Jackson Hole conference. We see volatility continuing, with the prospect of relief only when we see further signs of cooling inflation.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
www.stifelinsights.com

FIGURE 1
Fed Forecasts Tell the Story



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