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MARKET SIGHT LINES

The Fed's Path to a Soft Landing: More 50-Basis-Point Hikes

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A year ago, the Federal Reserve (Fed) expected higher inflation to be transitory. That has not been the case. For the year ended March, the consumer price index (CPI) was up 8.5%, with core CPI (ex-food and energy) up 6.5%. But we've explained that we believe inflation has peaked, in part the result of a hawkish shift in Fed policy. Economists were surprised by the Bureau of Economic Activity's (BEA) first estimate of first-quarter 2022 GDP, which dropped by an annual rate of 1.4% – a signal of increased risk of recession, which combined with elevated inflation would mean stagflation. So, investors were interested to learn the results of this month's Fed meeting, including the Fed's continued shift in policy and outlook from here.

In this week's Sight|Lines, we review inflation, the first estimate of U.S. first-quarter 2022 GDP, and the learnings from the Fed's May 2022 meeting.

PEAKING INFLATION AND FED POLICY

As mentioned, we recently profiled the debate on whether or not inflation is peaking, and offered our view that inflation has peaked. After the aforementioned 8.5% rise in CPI for the year ended March, the consensus forecast for CPI for the year ended April is 8.1%, down 0.4%. The consensus forecast for 2023 and 2024 CPI are 3.0% and 2.3%, respectively, and break-even forward CPI growth rates, a popular market-based measure, forecast the one-year breakeven at 4.9% and two-year breakeven at 4.1%. All of these measures are signaling an inflation slowdown. But importantly, economists and investors believe the Fed has the room to implement a more hawkish policy without risking a recession. So, a fall in first-quarter GDP may be a headwind to such a policy shift.

THE BEA'S FIRST ESTIMATE OF FIRST-QUARTER 2022 GDP

Let's dig in a bit on the BEA's first estimate of first-quarter 2022 GDP, which showed a drop of 1.4%, following a 6.9% rise in the fourth quarter of 2021. As is often the case, the report highlighted areas of strength and weakness in the economy, as measured by GDP. In the first quarter, a large rise in the trade deficit, along with declining inventories and government spending muted growth. For example, motor vehicle dealer inventories fell substantially, with more cars being sold than delivered to dealers. The rise in our trade deficit was fueled by increases in imports for durable goods like nonfood and nonautomotive consumer goods. Solid positive contributors to GDP in the first quarter were consumer demand and business investment. The rise in consumer spending was led by services, like healthcare, and stronger business spending included equipment (information processing) and intellectual property products (software and research & development).

THE FED'S RECENT HAWKISHNESS CONTINUES

On Wednesday morning, the futures markets were pricing in a 98% chance of a 0.5% increase in the federal funds rate, and the Fed did what was expected. In its statement, the Fed acknowledged that Russia's invasion of Ukraine is "creating additional upward pressure on inflation…" and that "COVID-related lockdowns in China are likely to exacerbate supply chain disruptions." As a result, "the Committee is highly attentive to inflation risks." Fed fund futures are pricing in 50-basis-point hikes at the next two meetings in June and July.

In his press conference, Chair Jerome Powell said that "inflation is much too high" and the Fed is "moving expeditiously to bring it down." And while he said that additional 50-basis-point hikes are "on the table" for the next few meetings, he provided some relief by acknowledging that 75-basis-point hikes aren't being considered. Powell expressed the view that there is a "good chance" for a "soft or softish" landing, meaning the economy will hold up through this rate hike cycle. He cited excess household savings, the strong labor market, and businesses being in good financial shape as supportive of a soft landing. In short, he said the economy is strong and well positioned to handle tighter monetary policy.

As we've discussed many times before, through the pandemic the Fed purchased securities to expand its balance sheet from $4.16 trillion to $8.96 trillion, another form of accommodative policy that increased the money supply and set the stage for higher inflation. In January, the Fed released its Principles for Reducing the Size of the Federal Reserve's Balance Sheet, saying it would "reduce…holdings over time in a predictable manner primarily by adjusting the amounts reinvested of principal payments received…" On Wednesday it released its Plans for Reducing the Size of the Federal Reserve's Balance Sheet, which laid out details of its quantitative tightening (QT) plan. The Fed will not reinvest up to $47.5 billion of maturities of Treasuries and mortgage-backed securities per month for three months, increasing those total caps to $90 billion after three months. Some investors interpreted the capping of QT at half of the maximum ($90 billion) for three months instead of a gradual step up as marginally more dovish.

Equity markets rallied during Powell's press conference, but erased these gains the following day, as several uncertainties continue to weigh on investors.

CONCLUSION

We started the year releasing our 2022 Outlook with a focus on balancing acts, including a discussion of the challenges the Fed would face this year. Now, with continued elevated inflation, a drop in GDP in the first quarter of 2022, and the threat of stagflation, the Fed's policy balancing act is even more challenging. We remain of the view that inflation has peaked and will recede later in the year and in 2023, a drop supported by the shift in Fed policy. While we acknowledge the increased risk of recession, we still see 2022 GDP growth as above trend, with a recession no sooner than the second half of 2023, and possibly later.

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