

Bringing inflation back to target at all costs

Friday, 06/17/2022

Yesterday the Fed hardened the tone to signal its determination to curb inflation. At all costs? After yesterday's 75bps hike, the market's reaction was not dramatic but all eyes will remain on the Fed's stance in the coming months.



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The facts

A "hawkish" message from the Fed:

- 75bps hike, the largest since 1994, which was expected since the last inflation numbers came out last week. Only one member voted for a 50bps increase (Esther George);
- The market now expects a 90% chance of a 75bps increase at the next meeting (July);
- The language has change to "firmly committed to bringing inflation to 2%" (they previously stated that they expected to bring inflation to 2%);
- The Fed is signaling to the market that their goal is to be 100bps above "neutral" in the next 2 years - a sign of very serious monetary tightening;
- During the conference, Powell said that more (upside) inflation surprises are possible. He opened the door to further 75bps hikes, even if he hinted at the fact that the next rate hike could rather be a 50bp hike. 16 Fed members see an upside risk to their inflation projections;
- Growth (+ employment) projections have come down, while inflation projections rose, highlighting the fact that the Fed acknowledges the strength of inflationary dynamics, and the negative impact that its policy tightening will have on growth and employment in 2023.

On the more dovish side:

- The new 2022 dot is "only" 3.4% (i.e. + 175bps additional rate hike), less than the ~3.8% anticipated by investors.
- The peak Funds Rate dot remains UNCHANGED at 3.8% (there was some concern this could have been hiked all the way to 4.8%)

Opinion

Overall, we are not overly surprised by this announcement. Our view remains unchanged. The Fed is now firmly committed to a restrictive monetary policy via rapid and pronounced tightening in order to control inflation. We are not paying too much attention to yesterday's market reaction to the FED's decision, which is more of a technical effect than a market repositioning. This technical move was fueled by hedge funds that had created large short positions on stocks in recent days, exploding to previously unseen record levels, as well as the repricing of the U.S. yield curve, with its biggest jump in two days since 1987.

Our feeling is that if the next inflation number is once again very high, the Fed could move even higher. The 75bps becomes the new 50bps...

Mr Powell tried to "manage expectations" during the press conference by mentioning that he doesn't "expect these [75bp] moves to be common", implicitly suggesting that the next rate hikes could be smaller ones of 50bps. However, he did not rule out another 75bp hike, and the past few months have shown that central banks' forward guidance are useless and irrelevant in the current context. The only driver is inflation data and inflation expectations, and the trajectory and pace of Fed Fund rates over the coming months will be shaped by their evolution.

The risk of this strategy is of course a severe slowdown of economic growth - or even a recession. The FED reaffirmed that the neutral rate, the one that neither harms nor stimulates the US economy, should be around 2.5%. With a policy rate well above 2.5% in the coming months, the US economy should be adversely affected in 2023/2024. Risky assets could therefore suffer further, while the long end of the US Treasury curve could soon offer buying opportunities. Indeed, the FED announced yesterday that most rate hikes would occur in 2022 while in 2023 they should be stable and 2024 should see the first rate cuts. In this scenario, the terminal rate should be close to 4%, which could be an initial buying target for the 10-year US Treasury yield. Note that in the past, the 10-year U.S. Treasury yield has rarely exceeded the terminal rate.

On the positive side, the fact that the Fed is now very quickly aligning itself with market expectations shows that it is determined to regain credibility.



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