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BREAKING NEWS
2 November 2022

# Fed rate hikes will continue until inflation improves

*The Fed has raised rates by 300 basis points since June, a nearly unprecedented pace of tightening done to combat persistent inflation amid continued strength in the labor market and consumer spending. But markets are worried it will go too far, triggering a recession.*

Brian Nick
Chief Investment Strategist

### WHAT HAPPENED?

Delivering on expectations, today the U.S. Federal Reserve raised its target policy rate by 75 basis points (bps) to a range of 3.75% to 4.00%. This is the fourth consecutive meeting to produce a hike of this magnitude, and it is not yet clear whether it will be the last.

The Federal Open Market Committee's (FOMC) statement following the meeting pledged to keep monetary policy "sufficiently restrictive" to return inflation to 2%. But it also said it would account for the "cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation."

In his remarks following the decision, Chair Jerome Powell was pressed for details on the Fed's plans for rate hikes at future meetings, particularly the next one on 14 December. Powell said he expects it may be time to slow the pace of hikes at the next meeting or the one after. But he tempered those remarks by saying the Fed might ultimately have to hike rates to a higher terminal level and keep them there for quite some time. Investors looking for firm signs the Fed may begin to take its foot off the brake in December certainly found a few.

### WHAT IS THE CASE FOR MORE HIKES?

On the surface, with every measure of inflation still well above the Fed's target, further rate hikes seem appropriate. In particular, the U.S. labor market has to this point been virtually undisturbed by the dramatic tightening of financial conditions. Powell has cited low unemployment and high wage growth as reasons for concern that inflation will persist. His conclusion: tighter policy will reduce demand for workers, thereby raising unemployment and short-circuiting the wage/price spiral. If this seems unpleasant, that's because it is designed to be.

Recent public comments from FOMC members have emphasized lower inflation as a necessary condition for large rate hikes to cease. That implies we are still a good distance away from a turning point toward stable, let alone easier, monetary policy. Yet trends in many of the *drivers* of inflation are providing reasons to be more optimistic that inflation may begin moderating over the coming months.

First, private measures of rent inflation are rolling over. Both the Apartment List and Zillow monthly national indexes show rent inflation falling quickly.

Second, the U.S. Employment Cost Index showed a decline in the rate of growth for private sector wages in the third quarter, even as the year-over-year number remained higher than average. Third, prices of core goods like appliances, which have fallen out of favor as consumers rotate to services spending, are in steep deflation. As consumer behavior normalizes further, companies with overstocked inventories may be compelled to slash prices on an ever larger basket of goods. Holiday shoppers should expect good deals.

To use a popular hockey analogy, based on where the puck is today, the Fed should continue to raise rates at a rapid clip. But based on where the puck appears to be going, the case for easing up on the hikes is becoming stronger. The Fed has until 14 December to examine the incoming data and make a decision.

## IS A RECESSION INEVITABLE IN 2023?

Whether the U.S. economy drops into recession in the coming quarters depends on how much tighter monetary policy becomes. If the consensus expectation of more than 100 bps of additional rate hikes before mid-2023 is correct, real GDP growth is likely to remain weak, perhaps flat, next year. Consumer spending should slow as excess savings wind down. Businesses will turn more cautious about hiring new workers or deploying capital. And construction activity will remain greatly impaired.

We continue to think a large rise in unemployment is unlikely given that hiring demand remains strong in Covid-impaired industries like airlines, food services and accommodations. A significant churn in employment, partly reversing the one in 2020, is likely as industries like construction and retail lay off workers as others scramble to hire them.

One implication of lower inflation and slower growth in 2023 is that corporate profit margins may be squeezed. We have already begun to see this in the consensus expectations for company earnings in 2023, which according to Bloomberg have declined by 4% since the middle of this year and almost certainly have further to fall. An earnings recession without a sharp rise in unemployment is rare but not impossible in 2023, given the unusual pattern of economic activity over the past few years.

## INVESTORS DEALING WITH UNCERTAINTY

The uncertain path of monetary policy – and its uncertain effect on the economy and corporate earnings – is forcing investors to choose from a list of risks to avoid as they prepare for 2023. Equity markets have rallied in recent weeks, as they did in March and July when investors convinced themselves that the worst of the tightening was behind them (they were wrong both times). Interest rates have fallen from their highs as stock prices have risen, but the behavior of financial markets from here will depend on whether the market pricing for the terminal fed funds rate (close to 5% today) rises further.

The vague but hawkish guidance from the Fed on the path of policy advises caution from investors. We are not dramatically increasing portfolio risk from here given a) the sensitivity that virtually all publicly traded assets have shown to rising interest rates; and b) the risk that the Fed may overshoot and help create a damaging recession.

Yet caution and paralysis are not the same thing. Investors who have wandered for years in search of ways to generate yield from their portfolios can finally rest their legs. With investment grade and high yield corporate bonds yielding close to 6% and 9%, respectively, hitting income targets is not as difficult as it used to be. Municipal bonds are generally backed by strong balance sheets and should perform well in a variety of scenarios, including both a moderate recession and a soft landing next year.

Within equity markets, we favor quality companies with strong free cash flows and, preferably, growing dividends. We remain cautious on high growth stocks while rates remain volatile, but prefer the U.S. market to others given its defensive qualities and the U.S. economy's relative outperformance.

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**Endnotes**

**Sources**

Federal Reserve Statement, November 2022.

Bloomberg, L.P.