

The Fed's "summer of 75" continues, despite growth risks

A higher-than-expected consumer price inflation report for June compelled the U.S. Federal Reserve to maintain its brisk pace of policy tightening. The U.S. economy is showing signs of slowing, which could lead the Fed to reduce its pace of rate increases in September.

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WHAT HAPPENED?

The U.S. Federal Reserve raised its policy rate by a whopping 75 basis points (bps) for the second straight meeting as headline inflation continues to accelerate. This move brings the fed funds rate target range to 2.25% - 2.50%, close to the Fed's estimate of neutral. But rates are nearly certain to move significantly higher before the end of the year. Markets are currently pricing in another 100 bps of hikes for the last three meetings of 2022.

This outcome was widely expected, despite markets briefly pricing in an even larger rate increase immediately after the release of the June consumer price inflation report earlier in July.

The lone material change to the FOMC's statement was a new reference to recent softening in spending and production. Chair Jerome Powell also mentioned in his press conference that the housing market has weakened and business fixed investment likely fell in the second quarter. However, Powell and his colleagues still see a healthy labor market as a sign the U.S. economy remains in a good place.

HOTTER INFLATION, COOLER GROWTH

The most notable changes to the economic and market landscape since the June meeting are the sharp decline in commodity prices and the broad-based softening of economic growth data across a variety of categories. Gasoline prices have retreated to their early March levels, while most agriculture and metals prices are now lower than they were at the start of the year.

These generally do not affect the core personal consumption expenditure price index, which the Fed uses to assess its 2% inflation target. But in recent months, Powell has put more emphasis on headline consumer price inflation, which could mean the Fed will consider declining food and energy prices as it determines whether its attempts to bring down inflation are succeeding.

Of course, one reason global commodity prices have fallen is that investors expect demand to weaken. The preponderance of data over the past eight weeks points to weaker growth in key areas of the economy, including manufacturing and home construction. Thankfully, U.S. consumers still have their wallets open, but real spending growth has fallen from its torrid pace just a few months ago. Europe and emerging markets remain under

significant threat from high energy prices, given the ongoing conflict in Ukraine and diminished oil and gas supply from Russia.

R.I.P. FORWARD GUIDANCE, 2004-2022

As the Fed attempts to navigate uncertainty around both the economic outlook and its own policy path over the balance of the year, it appears to have cast overboard a key tool for setting market expectations: forward guidance. Forward guidance is anything a central bank does to provide the public with information about the future of monetary policy. In practice, it's allowed the Fed to shape expectations to minimize surprises and the volatility they bring. But it has become harder to execute with credibility as the economy has undergone massive shifts in the past two years.

On cue, Powell was vague about what the Fed plans to do at its next meeting on 21 September. Markets are looking for the pace of rate hikes to slow soon, but the Fed is making no such promise. Instead, it wants to examine the incoming data over the next eight weeks, including two employment reports and a slew of inflation readings. Decisions on rates will occur "meeting by meeting."

Just last week the European Central Bank (ECB) also abandoned forward guidance, raising its policy rate by 50 bps when markets had expected only 25 bps. ECB President Christine Lagarde made things even clearer in her press conference, saying "We are much more flexible, in that we are not offering forward guidance of any kind."

Without forward guidance, expectations for central bank policy over the balance of 2022 will be subject to considerable volatility. This may be unavoidable, given that the Fed itself has been challenged to accurately forecast inflation. But investors are looking for a life preserver as they tread water in the sea of red ink on their financial statements. Instead, central banks may have thrown them an anvil.

SO WHY ARE MARKETS SO CHIPPER LATELY?

Even without much to go on from the Fed, investors seem to have turned slightly more optimistic over

the past month. The S&P 500 Index is more than 8% above its mid-June lows, spreads on corporate bonds have narrowed and outflows from the municipal bond market have finally ceased.

This hopeful tone has set in despite generally disappointing economic data (the U.S. labor market and consumer spending are significant exceptions here) and the dual threat of geopolitical shocks and looming monetary tightening.

The best explanation for the synchronous rally is that markets, like us, do not believe a severe U.S. recession is likely even if policy tightens a bit more from here. A slowdown in economic growth is inevitable at this point, but strong private sector balance sheets and surprisingly persistent hiring growth should prevent a steep rise in unemployment.

Of course, there are some conflicting opinions about this, which we can see from the recent drop in the 10-year U.S. Treasury yield. This, coupled with the hawkish Fed posture, has inverted the yield curve, a traditional harbinger of recession. Fed funds futures markets, left to their own devices in the absence of forward guidance, are pricing in another 100 bps of rate increases from the Fed by the end of the year followed by a few cuts starting in the first half of 2023. This path could help stabilize the economy, but it assumes that inflation will abate and allow the Fed to focus more squarely on growth.

In our base case, market returns should continue to improve from here. But we recognize that further upside inflation surprises and the policy response they would invite pose risks to this view.

As such, we are relatively conservative in our asset allocation posture, with preferences for U.S. high yield credit over equities and a strong overweight to high quality municipal bonds. Investors looking for a way to play our base case for softer growth without a severe recession should consider quality growth stocks, which have been beaten up by the interest rate cycle this year.

For more information, please visit us at nuveen.com.

Endnotes

Sources

Federal Reserve Statement, July 2022.

Bloomberg, L.P.

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