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PART II

What Will the Fed Do Next?

By: Sawyer Rothmann

What will the Fed do?

This is the question that every Financial Advisor has found themselves asking more frequently this past year. A question that, given the correct answer, is the holy grail to investing for the foreseeable future. A question people all around the world are trying to take educated guesses on in pieces that, when printed out, are thicker than the Accounting Desk Book or your child's Harry Potter book collection.

The Federal Reserve (Fed) has again raised its projection for the peak federal funds rate. And once again, the stock market has had to adjust to the potentially higher rate, with the S&P 500 Index off about 4% during the last three days. There are some differences now compared to earlier episodes this year, however. The first is that inflation reports are now coming in softer than expected. The benign October Consumer Price Index (CPI) reading was regarded suspiciously. But November's CPI—combined with declining commodities, freight costs, goods prices and rents—lends credibility to the belief that inflation is coming down at a meaningful rate. Additionally, the bond market is telegraphing its suspicion that the Fed will not let interest rates get as high as it projects. The 2-year U.S. Treasury sits at 4.25%, well below the Fed's projection of a 5.10% peak federal funds rate.

Finally, the drumbeats from market commentators that the Fed is getting it wrong grows louder. Bond manager Jeffrey Gundlach, market researcher Ed Yardeni and economics professor Jeremy Siegel are a few of the noteworthy critics of the Fed. Will the Fed wreck the economy by raising rates too far as inflation comes down? At some point, the second of the Fed's dual mandate—full employment—will gain the upper hand. Not yet, but it might be soon. All this suggests that the stock markets' negative reaction to the Fed's continued hawkishness may soon be done. It is plausible that the Fed continues to talk tough as a legitimate tool to work inflation lower. Time will tell if Fed officials are indeed bluffing, as the above indicators seem to suggest.

The Federal Open Market Committee held its December two-day meeting last week, which resulted in a raise of the target federal funds rate, as Fed officials continue to battle with elevated inflation.

What has the Fed done?

As expected, the Fed raised its policy rate 0.50% to make the new target range 4.25%–4.50%. As the Fed does at every meeting, they also released their updated Summary of Economic Projections. The updated report included a slightly higher forecast for the terminal rate and a slightly higher forecast for the jobless rate next year.

What was the Fed expected to do?

While predicting what the Fed will do is a bold undertaking, using the yield curve prior to the meeting, we could extrapolate that the Fed was largely expected to hike half a point, bringing the overnight borrowing rate to a range of 4.25%–4.50%. Many investors were (and still are) patiently awaiting the Fed to hint toward a further slowing of the pace of rate hikes. This was the first rate hike that showed a deceleration from the Fed's year-to-date pace. The Fed had previously raised rates 75 basis points in the beginning of November.

Is it too much too fast?

Here are the facts: So far this year, the Fed has hiked more than 25 basis points five different times including today. That is fast. Prior to this year, the Fed was on a 22-year streak of not doing that a single time. The 425 basis points of cumulative hikes is the most in a year since 1980. It has been a historical year for rate hikes. Whether it is too much too fast will be revealed over the coming months and likely even years as the full effect of these rate hikes play out. Fed Chair Jerome Powell has acknowledged multiple times that the Fed is acutely aware of the lagging effects of tight monetary policy.

Powell: Santa or Grinch?

Going into this Fed meeting seemed analogous to running downstairs on Christmas morning. The only difference is you truly didn't know if you were naughty or nice. Investors were hoping to see one big present wrapped in various dovish rhetoric. Instead, we got a manila-colored bag of coal-dusted socks.

The Coal:

- "No rate cuts until the committee is confident inflation is moving towards our 2% goal in a sustained way."
- "I don't think anyone knows if we're going to have a recession or not and if we do, whether it's a deep one or not. It's not knowable."
- "Policy will need to remain tight for some time."

The Socks:

- "We're getting close to that level, we think, of sufficiently restrictive."
- "It does seem appropriate to move to a slower pace (of rate hikes)," but "we can't tell today what the actual size of that will be."

What to watch

There is a myriad of data that the Fed and investors watch to stay connected with where we are in the inflationary environment and economic cycle. PCE (Personal Consumption Expenditures price index), CPI, GDP (gross domestic product) . . . take any three random letters and there is probably an existing indicator out there that it stands for. We watch them closely. The one that Powell shouted out was non-housing core services inflation, which is a component of the CPI. This is the type of inflation that is sticky, and the tighter the labor market gets, the stickier it becomes. Powell is hopeful that we can find a soft landing because he believes there is a path in which job vacancies are reduced and companies are willing but resistant to lay workers off. Right now, companies are so aware of the difficulty in finding new employees that they are willing to pay more to keep the ones they have from leaving. This enables wages to grow faster than inflation. The longer wages grow faster than inflation, the more likely inflation is to become entrenched. Don't know what entrenched inflation is? Read my last post!

Why is the labor market so tight?

Every time since 1945, when the Fed hiked rates, unemployment has shot up. Now, of course, a sudden spike in unemployment is a horrible thing, but a slow climb that creates more competition in the labor market could result in increased price stability and lower wage inflation. The Fed is forecasting an unemployment rate of 4.6% next year, but the rate currently sits at a stubborn 3.6%. So why isn't unemployment really budging given the tightening financial conditions?

There are many reasons why there aren't enough workers in the labor force today. Some are temporary; others are more permanent and could indicate we have a more structural issue in the labor market. Powell singled out two causations that may point to more enduring issues: (1) labor participators whose physical health was affected by the pandemic and (2) low immigration. Both factors certainly contribute to the high job vacancies and lower post-COVID labor force participation, but to what extent, we aren't positive. There is a slew of other things to consider including baby boomers aging out of the workforce, skill gaps within the labor market, and technological progress within automation. What we are sure of is that analyzing inflation goes hand in hand with analyzing the shortage of workers and the resulting wage inflation.

So, what will the Fed do next?

While I boldly guessed a 50-basis-point hike for this meeting in my last post, I can't guess what will occur during the next Fed meeting. There is too much time and too many catalysts between now and the end of January. We will carefully watch our favorite three-lettered economic and inflationary indicators, company earnings reports and the hundreds of other qualitative and quantitative red or green flags that are sure to reveal themselves over the next 45 days.

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