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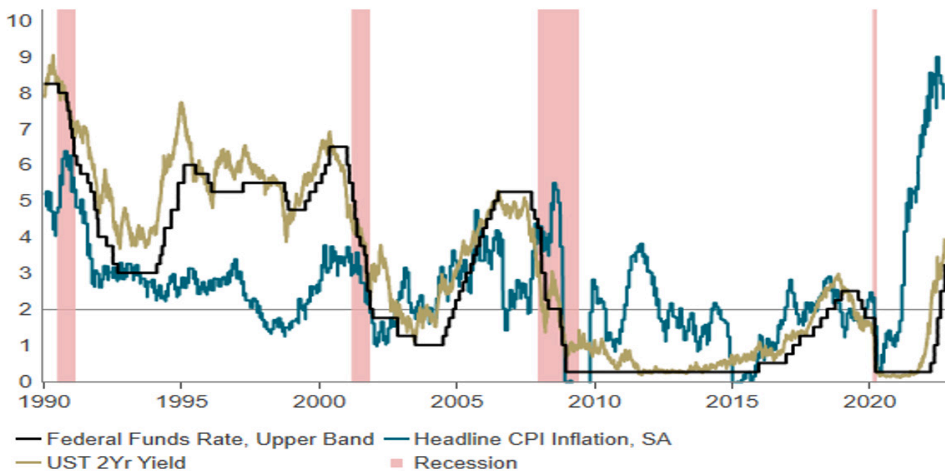
September FOMC: Fed Still Hopes For A Soft Landing

GLOBAL ECONOMICS & INVESTMENT ANALYSIS | SEPTEMBER 21, 2022

- **The Federal Reserve Open Market Committee (FOMC) raised its policy rate by 75 bps to 3.0-3.25% at the September 2022 meeting.** This move largely met market expectations.
- **The Summary of Economic Projections (SEP) featured an updated forecast of the fed funds rate, incorporating an additional cumulative 125 bps hike by year-end 2022, and another 25-bps hike in 2023, with the target fed funds rate peaking at 4.6%.** The Committee appeared somewhat split on the 2022 forecast, however, with some favoring a cumulative 100 bps of hikes by year-end. The FOMC indicated they then expect to lower the policy rate to 3.9% in 2024.
- **By front-loading hikes in 2022, and keeping policy rate in "restrictive" territory until at least 2025, the Fed aims to short-circuit a so-called "wage-price spiral":** a scenario in which rising prices and a strong labor market induce employees to keep asking for wage raises, which in turns continues to push up prices.
- **In exchange for tolerating an above-target inflation in 2022 and 2023, the FOMC expects their actions to induce only a mild recession.** Further, the FOMC expects its course of action to be sufficient to bring inflation down to target (2.0%) within 2 years. The SEP projects GDP growth of almost zero (but not negative) in 2022 and just above 1% in 2023; unemployment to peak at 4.4% in 2023-2024.
- **The Fed's own forecast of a mild recession may prove too optimistic.** Historically, increases in unemployment rate have been very persistent, meaning that once the unemployment rate begins to rise, it's hard to stop it from increasing. Raising policy rate by almost 450 bps in one year but keeping unemployment from rising by more than 100 bps is a very challenging task for the central bank, one that history has shown to have a low probability of success.
- **Markets appear sanguine so far that the Fed may avoid a sharp recession, but that could change if/when economic data weakens, and unemployment begins to rise.** Following the FOMC event, the fed funds futures quickly adjusted close to the SEP projections, and the US Treasury curve changed only modestly, on net. Equity markets seemed to respond to the FOMC event by declining over 1% initially but reversing the declines during Powell's press conference, though they weakened again into the day's close.
- **Retail investors appear to have been a broad source of support for the equity markets, but this could change as the Fed continues to raise rates.** Strong consumer and corporate balance sheets appear to have helped shield US equities from even greater declines in 2022 as rates rose. However, this could change as the Fed continues to raise rates. However, as excess savings are worked through, retail spending may weaken before inflation declines meaningfully, pressuring corporate valuations lower.
- **Higher US policy rate is expected to translate into a stronger USD, all else equal.** This could present challenges to emerging market economies. Those with large USD-denominated sovereign or corporate debt liabilities that may need to be rolled over soon at a more onerous cost. US multinationals will also likely see margin compression as a result of the stronger USD, all else equal.

Fed Funds Rate, Inflation and US Treasury 2 Year Yield

Despite aggressive hikes in 2022, the inflation-policy rate remains gaping



Source: Macrobond, BNY Mellon Investment Management

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