Fed's Hawkish Messaging Maintains the Pressure

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Despite recent improvements in the inflation data, the Federal Reserve doused market hopes for a more dovish tack ahead. The Fed's latest economic projections signaled an even more hawkish path than its September forecasts as well as a weaker economic outlook amid slower growth and higher unemployment (Figure 1). Taken together, we see three overarching messages from the Fed: 1. it will persist until inflation reverts to target; 2. that reversion will require higher rates for longer than previously expected; and 3. growth will suffer and unemployment will rise - but those are prices worth paying in order to achieve the inflation target.

From the Fed's perspective, today's meeting carried the whiff of a bumpy landing on the economic horizon. Growth projections for 2023 were revised lower to 0.5% - a on the cusp of recession - while core PCE projections were revised higher to 3.5% by the end of next year. Meanwhile, the peak policy rate was revised higher by 50 bps to 5.1%, at the top end of expectations, followed by 100 bps of cuts in both 2024 and 2025.

FIGURE 1: Fed's Projections Indicate Some Pain Ahead

Variable	Median				
	2022	2023	2024	2025	Longer run
Change in real GDP	0.5	0.5	1.6	1.8	1.8
September projection	0.2	1.2	1.7	1.8	1.8
Unemployment rate	3.7	4.6	4.6	4.5	4.0
September projection	3.8	4.4	4.4	4.3	4.0
PCE inflation	5.6	3.1	2.5	2.1	2.0
September projection	5.4	2.8	2.3	2.0	2.0
Core PCE inflation	4.8	3.5	2.5	2.1	
September projection	4.5	3.1	2.3	2.1	
Memo: Project appropriate policy path					
Federal funds rate	4.4	5.1	4.1	3.1	2.5
September projection	4.4	4.6	3.9	2.9	2.5

Source: Federal Reserve.

When asked, Chair Powell stressed the importance of financial conditions reflecting the Committee's intended policy restraint. He explained that we are transitioning from a regime where the speed of tightening was the most important variable, to one where the length of time at peak policy is the most critical aspect of achieving the Fed's dual mandate.

At this point, the Fed's reaction function has been overtaken by data. In other words, the clear downshifting of inflation pressure - especially in the category the Fed can most influence by cooling the labor market (i.e., service prices, ex-shelter) - is a stronger signpost for Fed policy than any forward guidance revealed in the Summary of Economic Projections. Hence, the Fed's projection for peak policy rates will be a fragile expectation that hangs in the balance with every major datapoint.

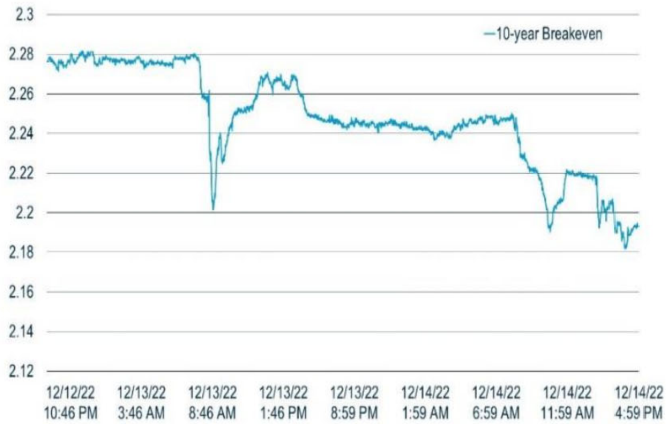
Looking ahead, the key macro question is whether mounting evidence of disinflation reflects the lagged effect of weakness in the global economy that will inevitably culminate in recession with global policies at restrictive rates for an extended period. The optimistic take, by contrast, sees the CPI data as an encouraging sign that the path to a soft landing isn't so narrow after all.

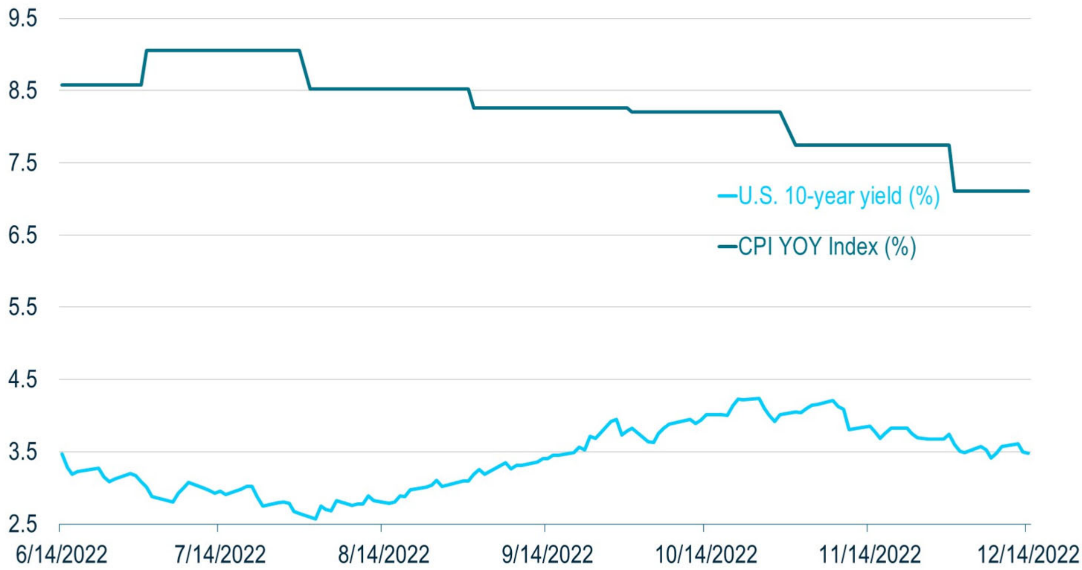
The markets may have more faith in the Fed than the Fed has in itself…

Market pricing is unduly dovish relative to Fed projections, with expectations for cuts beginning in Q4 2023 and tracking roughly 75 bps less than the Fed's projections for year end 2023 and 2024. As a result, the Fed's ongoing hawkish slant suggests additional upward pressure on rates and a possible steepening bias in the yield curve. Furthermore, the Fed's desire to keep financial conditions tight is likely to dampen risk appetite, keeping equities and credit spreads on the defensive.

However, the market biases suggested above - higher rates and dampened risk appetite - only played out briefly in the markets today, with interest rates actually ending lower on the day despite the Fed raising its expected path for rates (Figure 2). Why? One clue may be seen in the reaction of Treasury inflation breakeven rates - the market's forecast of inflation from the TIPS market. In one of today's larger moves, long-term inflation expectations, as measured by Treasury breakevens, declined by roughly 5 bps, and this was from a starting point already near the Feds 2% target. The low level of breakevens and their further decline today underscore the market's faith in the Fed to return inflation to the 2% target.

FIGURE 2, 3, and 4: Yields ended lower on the day, while breakevens - already near the Fed's target and significantly below actual inflation - fell further on the day as well.





Source: PGIM Fixed Income and Bloomberg.

Hawkish, but ginger movements boost the odds of a soft landing …

One reason the markets may have taken the news about higher rates so well could be found in the Fed’s intention to downshift its pace of hikes. Now that it has boosted rates over 400 bps, officials feel that they have the latitude to be more circumspect going forward, or as Powell put it, to “go slower and feel our way.” While that may seem like common sense, the fact of the matter is that it is in stark contrast to the rough or hard landings in the past in which the Fed hiked at an accelerating rate - until it was too late.

Conclusions

Today's more hawkish Fed outcome underscores its commitment to maintain tight policy until the job is done. While this may entail a 5% Fed funds rate through the end of 2023, markets are taking solace in its shift to a slower, more deliberate course of rate hikes, which improves the odds of a soft landing.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income.

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