Bond Blog

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PGIM FIXED INCOME

The Fed's Tightening Campaign: Slower, Higher, Longer

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The Fed delivered a two-act performance today that will likely shape expectations for "(even) higher for longer" policy rates - with an ultimate destination that the Fed now expects to reach at a slower pace.

In the first act - the policy statement - the Fed made a gutsy and meaningful decision to drop a dovish signal in the precious and carefully scrutinized real estate that is the outlook paragraph. Specifically, the Committee said it "will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." We read this sentence as a deliberate signal - backed unanimously by the Committee - that reveals officials' desire to downshift the pace of rate hikes to 50 bps as early as December, so long as the upcoming inflation data cooperate.

To us, the Fed's first message aims to carve out space for forward-looking judgments as policy becomes more restrictive and downside risks to economic growth become more visible. Put differently, given the lags of policy to affect the economy - set against a global backdrop of rapidly tightening financial conditions - waiting for the spot inflation data to soften before slowing down the pace of rate hikes would be a mistake in risk management.

In the second act - the press conference - Chair Powell delivered a hawkish encore to the dovish policy statement. Throughout the Q&A session, the Chair was at pains to de-emphasize the importance of the tightening pace; instead, he focused attention on the ultimate level of the policy target and the duration of keeping rates at the peak. On the latter measure, Powell underlined several times that "it is very premature to be thinking about pausing" rate hikes. He added that the Fed has "a ways to go" before monetary policy is sufficiently restrictive to bring inflation back to target, even if the destination remains unknown, as "there is no sense that inflation is coming down" at present.

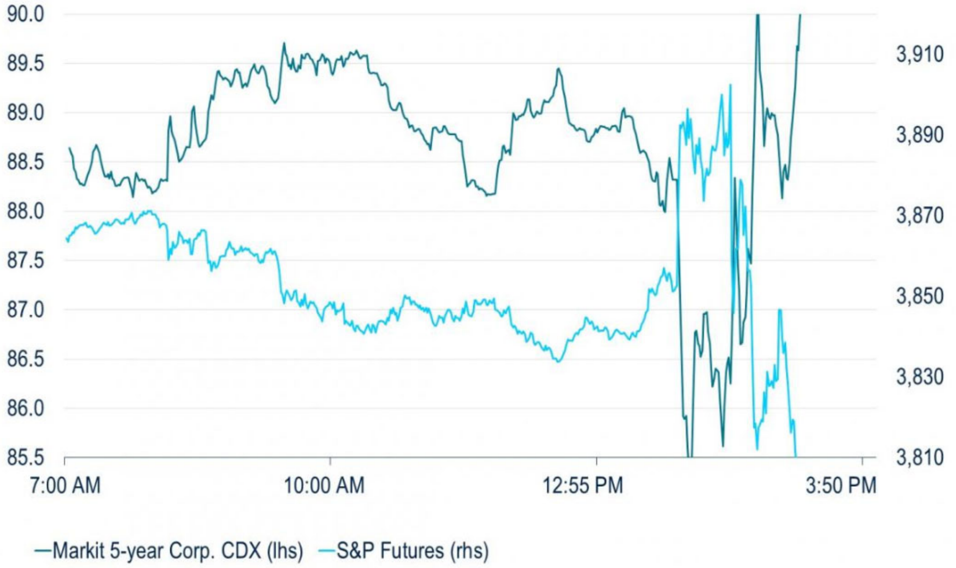
Taken together, the Fed established multiple thresholds for the contours of the unfolding tightening campaign: a relatively low threshold for slowing the pace of rate hikes, as early as December, coupled with a much higher threshold for pausing rate hikes altogether. Ultimately, the Fed intends to hike rates even higher for longer than previously assumed, but it will get to its ultimate destination more slowly.

Bear Hibernation ?

Although markets were initially buoyed by the Fed's introduction of the concepts of time lags and the cumulative impact of hikes into the statement, the optimism faded as the Chair explained in the press conference that expectations for the peak rate of the cycle had risen since September in response to worse-than-expected inflation data.

Price action during the press conference likely reflects the key to future market movements: credit spreads and equity markets may remain on edge until inflation crests (Figure 1). While there are a number of forward-looking signals that suggest that time may be at hand, to date, calling the top in inflation has been a fool's errand.

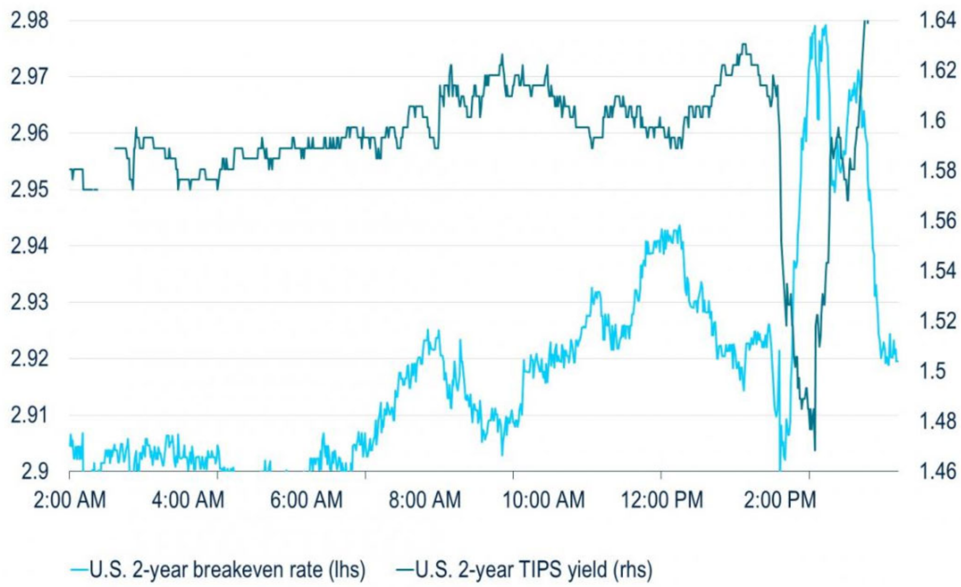
FIGURE 1: Risk markets, especially stocks, remain on edge: Initially buoyed by the cautious pace of hikes suggested in the statement, the potential threat to growth from the more hawkish tack taken during the press conference left stocks lower and credit spreads a touch wider on the day. (%)



Source: Bloomberg and PGIM Fixed Income.

However, the rates outlook may be a bit more benign. Although the Fed is clearly biased to hike significantly further this cycle, the market has more than 100 bps in additional hikes priced in over the next two quarters. This substantial buffer may afford the bond market an opportunity, at a minimum, to pause and wait for the actual Fed funds rate to catch with the relatively steep market pricing (Figure 2).

FIGURE 2: Subtle reaction in the bond market today: Real yields were little changed, but inflation breakevens increased, especially at the front end of the curve, taking nominal yields higher in expectation of a protracted fight to bring inflation under control. (%)



Source: Bloomberg and PGIM Fixed Income.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of November 2, 2022.

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