# Powell Soft Pedals 75 bps Hike as Markets Remain on Edge

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The Federal Reserve assumed an even more aggressive stance at its meeting on June 15 in light of persistently high and broad-based inflation readings and indications - at least from a few measures - that medium-term inflation expectations are starting to march higher. While the markets took a breather and immediately rallied after the meeting, they clearly remain on edge. The Fed's ultimate ability to achieve a soft landing - which it concedes may be out of its control - will likely determine the peak levels for long-term rates and credit spreads.

By hiking 75 bps at its June meeting, as forecasters had come to expect just ahead of the announcement, the Fed lifted the fed funds rate to 1.5%-1.75% - the same level that prevailed just ahead of the covid crisis. In addition to the accelerated pace, the Fed stepped up and pulled forward its projected future rate hikes, indicating it now expects the fed funds rate to double from here over the second half of this year to end 2022 at 3.4%. Fed forecasts expect modest additional tightening next year, bringing the fed funds rate to 3.8% by the end of 2023 before settling it back to 3.5% by the end of 2024. Chairman Powell noted that 75 bps hikes are unusual, but, nonetheless, the Fed would likely debate whether to hike 75 or 50 bps again in July. He also reiterated, though, that Fed decisions will remain flexible and sensitive to incoming data.

Even with a more aggressive policy tightening path, the Fed's updated economic projections still imply a soft landing as the Fed's base case. Powell emphasized the U.S. economy remains strong and can withstand tighter monetary conditions. However, in the press conference, he noted that there are many factors besides Fed policy that will influence the outlook for both inflation and economic growth going forward - e.g., fallout from the war in Ukraine and more persistent supply chain disruptions. In fact, Powell noted, there is now a much larger probability that a soft-landing will depend on factors outside of the Fed's control.

The Fed downgraded its economic growth projections to just under 2% over the next three years (1.7% this year and next; 1.9% in 2024) and notched its unemployment projections higher (to 3.7%, 3.9% and 4.2% by the end 2022, 2023, and 2004, respectively, compared to 3.5%, 3.5% and 3.6% in their March estimates). But those projections are very close to the Fed's long-run assumptions for growth and unemployment and are consistent with a soft-landing. The Fed's inflation estimates are now higher for this year - particularly in the case of headline inflation (now 5.2% by end-2022, with core at 4.3%), but are still expected to drift lower over the following two years to end 2024 in the low 2% range. Asked what the Fed would do if it faced a trade-off over bringing the inflation rate down or letting the unemployment rise more than projected, Powell noted that the robust labor market they're seeking depends on maintaining price stability over the long run.

### Where to from Here?

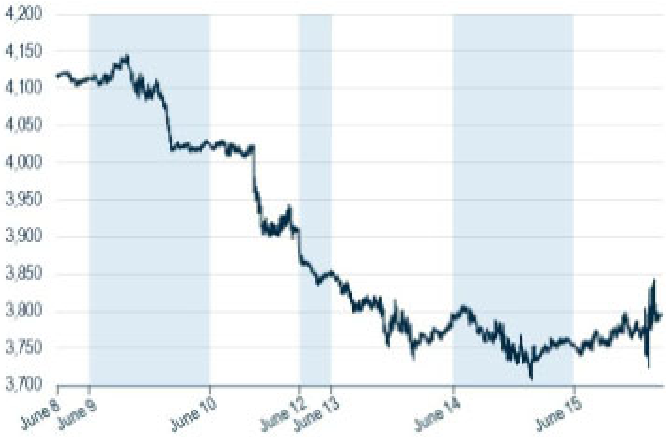
If the Fed follows through with an additional 75 bps hike at its meeting on July 27, it will have taken the fed funds rate from ~0% to ~2.5% - the Fed's estimate of the long-run neutral rate - in just 4 ½ months. From there, any additional hikes can be seen as policy crossing from a removal of accommodation to outright restrictive territory. Financial conditions have front-run much of this expected tightening, and interest-sensitive activity already appear to be responding. The pace of existing home sales has largely unwound its surge of the last two years, while new home sales have flatlined. The combination of a 37% increase in home prices since the start of the pandemic and an almost doubling of mortgage rates this year has caused housing affordability to plunge. Meanwhile, real retail sales have been decelerating this year, and they declined 1.2% in May (although some of the weakness represents a long-anticipated shift towards more consumer spending on services rather than goods). With core inflation pressures appearing much more persistent than previously expected, we expect the Fed will largely follow through on the rate hikes it has laid out for the rest of this year. Although, with both demand and supply factors contributing to the inflation surge, we agree with Powell there remains a high degree of uncertainty around these projections.

### A Short-Lived Sigh of Relief

After a brutal, bear-flattening selloff earlier this week, markets were more than braced for Wednesday's 75 bp hike. Combined with Powell's emphasis in the press conference on the goal of a soft - not hard - landing, markets let out of a sigh of relief as seen in the bounce in stock prices, narrowing credit spreads, and - even more emphatically - in the bull-steepening move of the U.S. Treasury curve as long rates dropped a few basis points, while 2-year Treasury yield tumbled nearly a quarter of a percent at one point (see the following panel of charts). However, the move was indeed a bounce as market's reversed course Thursday morning.

Markets breathed a temporary sigh of relief as the Fed emphasized its soft-landing objective. The Treasury curve rallied with short-term rates falling more than long-term rates, stocks rose, and credit spreads narrowed. Notably, however, these moves erased only a portion of the damage done on Monday when the Fed's intention to hike 75 bps - and not the smaller 50 bp move signaled in May - rocked the markets, and that trend continued Thursday.

**FIGURE 1: Following the Fed's announcement, S&P 500 Futures climbed more than 1% on the day (index level)...**

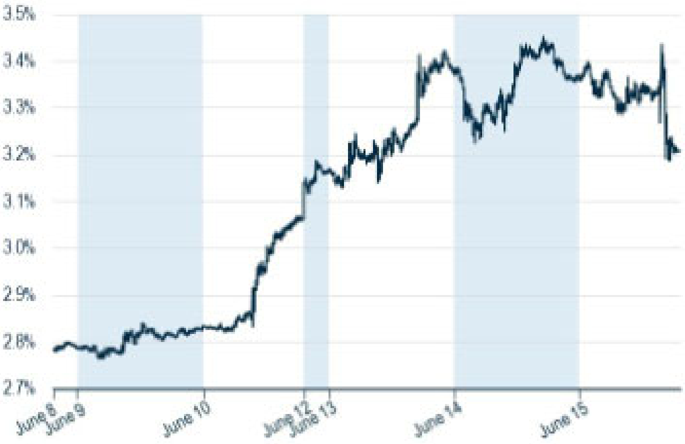



Source: Bloomberg.

**FIGURE 2: Spreads on IG corporate credit defaults tightened by 4 bps on the day...**

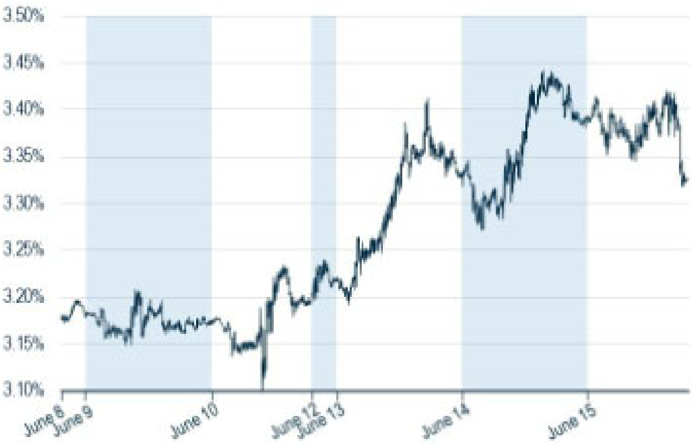

Source: Bloomberg.

**FIGURE 3: The two-year Treasury yield tumbled more than 20 bps...**




Source: Bloomberg.

**FIGURE 4: And the 30-year Treasury yield fell by more than 9 bps on the day..**




Source: Bloomberg.

Ultimately and perhaps as observed early Thursday, the market will return to the Chairman's opening comments that emphasized the need to get inflation down, and that, in all likelihood, will require market interest rates to remain at least around current levels. As a result, we expect market-determined rates to enter a range around current levels. This is typical in rate hike cycles: once the market moves well ahead of the central bank, yields tend to consolidate as they wait for the central bank to catch up. At this point, there's a 200bps gap between the mid-point of the Fed's target range (1.63%) and the market's pricing of an expected peak in the Fed funds rate (3.8%) by the Spring of 2023, even after today's decline of 20 bps. So, this consolidation could last for several weeks, if not months, depending on the flow of economic data and geopolitical events. Just as the rapid recent rise in rates caused a taper tantrum-esque widening in credit spreads, the risk markets may also experience a respite if and as rates remain range bound.

At present, it is too soon to call the ultimate destination for long-term rates and the credit cycle. That will have to wait until it becomes clear how the Fed's fight to contain inflation concludes. In particular, the ultimate peak in rates will key off of the peak Fed funds rate with the course for credit spreads set by the Fed's failure or success in achieving a soft landing.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of June 16, 2022.

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