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Short-Term Pain, Long-Term Gain?

By Ellen Gaske, PhD, CFA, Lead Economist, G10 Economies,
and Robert Tipp, CFA, Chief Investment Strategist, Head of Global Bonds

The FOMC hiked the Fed funds rate 75 bps at today's meeting and significantly ratcheted up its expected path for the for the Funds rate over the next few years. Market reactions were predictable given the hawkish outcome: higher short rates, lower stock prices, and wider credit spreads. Yet, the Fed could be nearing the end of the hiking cycle, and long rates - which fell following the meeting - may be near their peak for the cycle.

Higher for longer was the clear message from the Fed at its FOMC meeting on September 21, 2022. As largely expected, the Fed hiked the Fed funds rate to 3.0%-3.25% and raised its projected terminal Fed funds rate to 4.6% in 2023. But in a more hawkish-than-expected move, coming on the heels of the latest CPI report which offered no reprieve from inflation, the Fed also pulled its overall tightening a bit forward, now anticipating a further 125 bps of rate hikes over its remaining two meetings this year. That would push the Fed funds rate to 4.4% by the end of 2022. In other words, Fed officials think they'll be close to done in another three months.

The Fed's updated economic projections marked this year's figures to the reality of this year's much weaker GDP growth and slightly higher inflation; next year's projections now reflect the tighter expected stance of monetary policy going forward. Real GDP growth estimates were dropped to just 0.2% on a 4Q/4Q basis in 2022 (roughly in line with consensus) and lowered to a below-trend rate of 1.2% in 2023. Inflation estimates were notched slightly higher this year and next to 5.4% (4.5% core inflation) and 2.8% (3.1% core), respectively. As if to emphasize the more aggressive policy stance, the Fed projected the unemployment rate will rise from 3.7% as of last month to 4.4% by next year - a signal they are serious about tamping down inflation pressures without going so far as to pencil in an outright recession. Their longer-run view of where the economy will ultimate land was unchanged, with newly added projections for 2025 edging close to that long-run steady-state view (as was expected).

The persistence and breadth of inflation pressures have been a surprise to the Fed and many forecasters. Similarly, the outlook for inflation is also uncertain, except that the seeds have likely been sown for a softening in many its components. The Fed has now raised the Funds rate 300 bps over the last six months and ramped up quantitative tightening to full speed as of September alongside aggressive tightening by central banks in most other countries. There are signs that the Fed's rate hikes to date have already had an impact, with existing home sales now having fallen seven months in a row, house prices and rents showing nascent signs of softening, and the huge boost to household wealth during the COVID era now in reverse.

Speeding 75 miles an hour along its tightening path, with lagged effects building, there is a risk the Fed will overdo its tightening, particularly as Fed officials rely on inflation outturns as of the previous month as their navigation guide. Recession risks have likely risen, given the Fed's more hawkish stance. If actual inflation does show signs of moderating - the softening of global oil prices against demand destruction in China and Europe is one such example already - the Fed will be able to let up, and a soft landing is possible. However, if inflation doesn't show more definitive signs of moderating in coming months, there is a risk Fed policy will lurch even tighter, elevating recession risks further. Our base case view is that the Fed will likely lift the Funds rate to 4.25%-4.5% (close to its updated projected path) by early next year, leading to a U-turn in policy that will ensue in the second half of 2023 as the economy and inflation pressures respond to the tighter financial conditions.

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Four Points of Market Implications

While plenty of uncertainty remains on the economic and market front, we can nonetheless try to reach a few market conclusions from today's events:

Point 1: In the Fed, the Long End Trusts … Long Rates Near their "Peak" Zone for the Cycle?

Despite the dramatic repricing of the front end in recent weeks, which continued through today - the 2-year Treasury, for a marker, is up over 100 bps in the past two months - the long bond is scarcely scratching new yield highs relative to mid-June. In fact, long Treasury yields declined today with both inflation expectation (breakevens) and real yield components declining. The price behavior of long-term inflation breakevens and rates in general suggest the market is - quite reasonably in our view - biting down on the Fed's commitment to rein in inflation over the next few years, and barring a higher revaluation of the Fed's trajectory, long rates may already be at what will turn out to be peak levels for this cycle.

FIGURE 1: Long Treasury Yields Declined Wednesday with Both Inflation Expectation (Breakevens) and Real Yield Components Declining, Reflecting the Market's Confidence in the Fed's Ability to Succeed in Containing Inflation in the Years Ahead (%)

Source: PGIM Fixed Income, Bloomberg.

Point 2: Pressure Release Valve: Short-Term Rates

The ongoing movement in the dots and today's rhetoric of Chairman Powell reflect the conflict to this point: the economy has failed to heel despite the Fed's rate hikes so far. This clearly leaves the front end of the yield curve on the firing line. If there is too much inflation as well as too much tension in the economy stemming from too much demand and too little supply, the Fed funds rate and short-term Treasury yields will serve as the pressure relief valve. The Fed is declining to give a destination, except for its reaction function that it will do whatever it takes to rein in inflation. So, while we believe enough is priced in to the front end, the fact remains that it's too early to call the end of this rate-hiking cycle and too early to call a top in short-term Treasury yields.

Point 3: Bumpy, but Maybe not Terminal for Risk Product…

The Fed is clearly willing to risk pushing unemployment higher - the Chairman as much as suggested they need to sacrifice growth in the economy to get inflation down to target - but is that a death knell for stocks and spreads? Today's weakness notwithstanding, to this point, stock prices are above and credit spreads are below the worst levels from June, suggesting that markets are not assuming a higher probability of a hard landing relative to June - but not by much. As a result, the outlook for risk appetite would have to be described as either half empty or half full, depending on how inflation evolves.

FIGURE 2: Although Short-Term Yields Continue to Make New Highs, at Least for Now, Stocks Remain Above Their June Lows and Spreads Below Their June Highs, Suggesting Markets Have Yet to Concede That a Very Hard Landing Is Ahead (LHS: Index Level, RHS: bps)

Source: PGIM Fixed Income, Bloomberg.

Point 4: Still Better than the Rest: the U.S. dollar's Path Remains Higher

While inflation is high and rates are moving higher in the U.S. as well as much of the rest of the world, in summary, the trend remains the same: the situation in the U.S. looks either less worse or better than the situation elsewhere in the world. Nowhere is this more clear than in currencies where today's FOMC outcome was simply a continuation of the standing trend: the dollar strengthened on average versus both DM and EM currencies, with no apparent change in the offing.

FIGURE 3: Fears of a U.S. Hard Landing Be Darned. As Far as the Currency Markets Are Concerned, the Situation in the U.S. Looks Less Worse Than the Rest of the World, and Hence Today's Move Kept with the Trend of Recent Months: Dollar Up, Other World Currencies Down (Index Level)

Source: PGIM Fixed Income, Bloomberg.

Conclusion

The Fed has signaled its determination to bring down inflation and continues to move the expected trajectory for the Fed funds rate higher in response. However, the market showed that it continues to have confidence in the Fed's ability to stabilize inflation and that long-term yields, barring another lurch higher in short-rate expectations, may already be in their "peak zone" for this cycle. As for risk appetite, although both stocks and spread product were weak following today's meeting outcome, they nonetheless remain better than their worst levels from June, suggesting that in the absence of an even more hawkish Fed and / or worsening fundamental backdrop, risk appetite may be in a stabilization process.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of September 21, 2022

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