GENERALI INVESTMENTS

MARKET COMMENTARY

The Fed is ready to fight inflation at (almost) any cost

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- **The Fed delivered another loud message to confirm that fighting inflation is an overarching priority, but eventually admitted that this will came at a cost, and that a soft landing will be hard to engineer. It hiked rates by the expected 75bps to 3.25% and plans to reach 4.5% in December, with a further 25bps increase in 2023.**
- **Growth was significantly scaled down and projected to remain below trend until at least 2023 with the unemployment rate seen to increase, but inflation is now forecast to remain much stickier than what stated in the past meeting.**
- **The slow growth and higher unemployment brought about by a long period of sizeable monetary restriction are considered the lesser evil compared with a protracted period of inflation that would require much more drastic action to eradicate.**

On top of the expected 75 bps rate hike, the September meeting showed that the Fed is determined to tighten monetary condition at an even faster pace and plans to keep rates at a restrictive level for longer. The very hawkish message delivered by the "dots" and the press conference aimed at dispelling market's perception that the Fed may give up keeping rates high for long for fears of a recession. However, the central bank also acknowledges that the high probability of a hard landing, even involving a recession, is the lesser evil compared to let inflation get entrenched in expectation by a less aggressive stance. A delayed action would be in the end much more painful.

The Fed aims at increasing rates by another 125 bp by December, even though Powell highlighted that there is a significant number of FOMC members that would be happy with "only" 100 bps. Then 2023 would see another 25bps rise (instead of the nearly 50bps cut priced by market ahead of the meeting): rate cuts will be appropriate only in 2024. By the end of 2025 the policy rate should be some 40 bp higher than the neutral one, despite the obvious risk for growth an employment of such a prolonged period of restrictive monetary policy. The slowdown of the economy and the impact of tighter money led to a significant downgrade of the growth projections. In 2023 Q4 GDP would be just 1.2% higher than a year before. Growth will remain below trend at least until 2025 and the unemployment rate is projected to increase by 0.7 pp within a couple of years: two necessary conditions to bring inflation back to 2%. Something that, anyway, will not happen before 2025 in the FOMC projections. Inflation is indeed projected to be sticker than what expected in June, with the core rate sill above 2% by year end 2024.

With the policy rate that has just entered the range in which it can be considered restrictive, chair Powell stated that the FOMC wants to see positive real rates across the yield curve for a prolonged period. Tighter financial conditions require several months to affect in full the economy and therefore it is hard to state a clear sequence of the next policy moves, although the evolution of the appropriate rate and the fact that on this occasion the role of the "dots" was not underplayed do not leave many doubts.

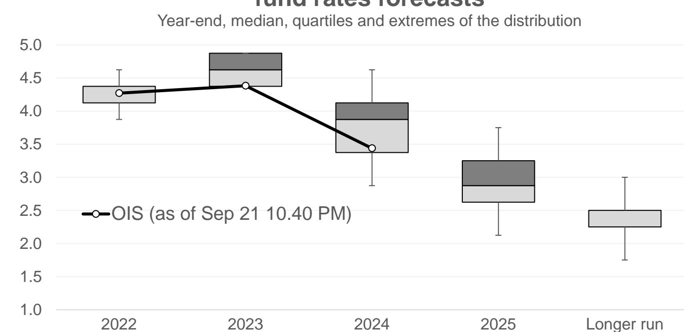
The Fed is clearly not yet afraid of overtightening, but Powell focused a lot to the risks that tight policy poses to the labour market. It continued to signal that the FOMC's preferred measures of demand and supply imbalances – the ratio of job openings to unemployed persons and the number of quits- have declined only marginally. In line with the thinking exposed since it started raising rates, Powel reaffirmed that it is possible to reduce job openings from the current unprecedented high levels without triggering sizeable layoffs. Two factors should help: inflation expectations remain broadly anchored and the abating of large negative supply shocks that buffeted the economy since 2020 will help drive down inflation. Supply disruption have just started unwinding and the process may be slow and uneven, he conceded.

Median projections					
	2022	2023	2024	2025	Longer run
GDP growth (Q4/Q4)	0.2	1.2	1.7	1.8	1.8
June projections	*1.7*	*1.7*	*1.9*		*1.8*
Unemployment rate	3.8	4.4	4.4	4.3	4.0
June projections	*3.7*	*3.9*	*4.1*		*4.0*
PCE inflation	5.4	2.8	2.3	2.0	2.0
June projections	*5.2*	*2.6*	*2.2*		*2.0*
Core PCE inflation	4.5	3.1	2.3	2.1	-
June projections	*4.3*	*2.7*	*2.3*		-
Appropriate path for the policy rate					
Federal funds rate	4.4	4.6	3.9	2.9	2.5
June projections	*3.4*	*3.8*	*3.4*		*2.5*

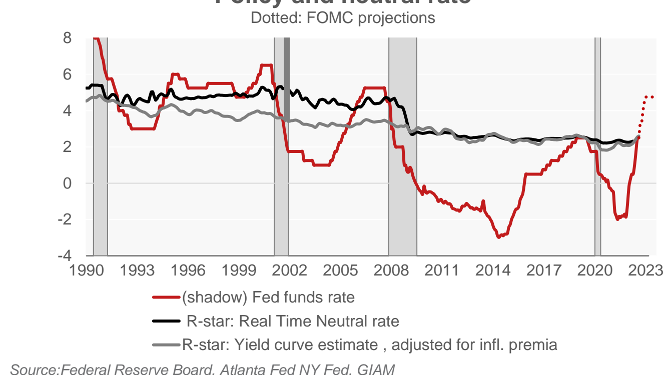
Yet the chairman sounded much less confident in the possibility of avoiding a hard landing. He clearly refrained from mentioning a recession but stated that there is a "very high" probability that growth will remain below trend for a substantial period. He also cautioned that there are no painless ways to fight high and persistent inflation, and that the sacrifices are needed to restore the situation prevailing in the Pre-COVID decade, when moderate inflation allowed a long period of smooth growth which greatly benefited the weakest part of the labour market. Only with very convincing evidence that inflation is steadily heading towards target, the Fed will start loosening policy.

We will revise our forecast of a Fed fund rate reaching 4% by the end of the year. However, the rapidly degrading international outlook and the deceleration of the economy will prove a very tough challenge to the Fed's determination to push rates to levels not seen since the mid-2000 and keep them there for at least one year.

The further hawkish twis was unsurprisingly badly received by markets, with the S&P sliding by 1.7%. The 2-yr yield rose to 4.1%the highest level in 15 years after the Fed statement.



Source:Federal Reserve Board, Datastream,GIAM estimates GIAM



Source:Federal Reserve Board, Atlanta Fed NY Fed, GIAM

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