GENERALI INVESTMENTS

MARKET COMMENTARY

The Fed dashes hopes of an early pivot

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July 28, 2022

- **The widely expected and unanimous decision to raise the Fed funds rate by 75bps for the fourth time was followed by the acknowledgment of the fast and sizeable tightening implemented. Moreover, the return of inflation to 2% will need to be gradual in order not to disrupt economic activity.**
- **But it is premature to think about pausing. The risk of not doing too much to stem inflation remain higher than that of overtightening. Rates may need to go up by more than what expected in September (4.6%, which is also our latest forecast), and this reduces the window for a soft landing. We expect just 0.2% growth in 2023 with an outright contraction in H1.**
- **Markets' hopes of an early pivot were disappointed again. After a brief rally before the press release, the S&P 500 dropped by 2.5%**

In today's meeting the Fed had to strike a difficult balance between acknowledging the sizeable tightening in financial conditions implemented so far and the need not to feed speculation about too early a pivot. Looking at the first market reactions, it succeeded. Hopes of a quick pivot were dashed, with the S&P losing 2.5% (as of 9.15 PM). The yield of on the 2-year treasury rose to 4.55% while the 10 year one remained stable at just above 4%

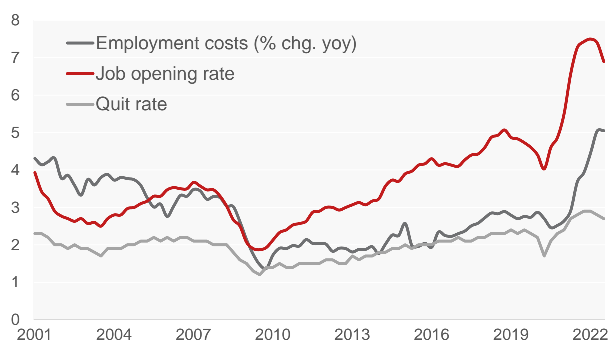
While the decision to rise rates by another 75bps was fully in line with expectations, the press release contained two big changes: first of all, monetary tightening aims at bringing back inflation to 2% over time, suggesting that the Fed will seek incremental improvements in inflation in order not to destabilise too much economic activity nor harming financial stability. Secondly, and crucially, the next steps will be determined considering the cumulative tightening implemented so far, and the lags with it will affect activity and inflation.

In the press conference, chair Powell did his best try to defuse the overall dovish tone of the communiqué: at some point the Fed will slow down but now a pause is not appropriate. The labour market remains exceptionally strong, and the recent weakening in some indicators like the quit rates is not enough to provide evidence of a cooling, given that the unemployment rate remains, at 3.5%, at a 50-year low. The latest data on wages show that they are still increasing at a rate not compatible to a 2% inflation. Powell conceded that there wage growth is not the main driver of the current inflation; there is no evidence so far of a wage-price spiral, but he reminded that once it shows up it is too late to intervene without crushing growth. Consumer spending remains healthy, tighter financial conditions are affecting capex and, above all the housing market. Risks to financial stability, however, appear contained given the tight discipline in credit supply. Overall and quite surprisingly, concerns about the high level of stress reached in financial markets were absent in the remarks.

Inflation remains high and there are few signs of a change of course; by preventing a smooth improvement of the labour market, this poses risks to both sides of the Fed's mandate. Goods price inflation has come down by much less than expected and services price increase continues steadily. Long term expectations remain anchored, but signs of deanchoring may appear too late to be addressed, so risk management consideration rule out a pause in hiking rate in the next future. The unprecedented nature of the inflation spike also calls into question the relevance of the experience in terms of lags between rate hikes, their impact on activity and how this feed into inflation. This too backs the need for further rate hikes, according to the FOMC.

After the historically fast pace of tightening, the important question now becomes, according to the FOMC thinking, the level of the terminal rate. There is still some ground to cover and the outcome will probably be a rate higher than that seen as appropriate in September (4.625%). What is the terminal rate and how long to keep the Fed funds rate there have been the subject of the November meeting and will continue to be discussed in December. The FOMC aims at seeing positive real rates

across the curve. Powell stressed that the Fed has not overtightened (yet) and not doing enough is much riskier than over-tightening. First, pausing too early would require, as in the early 80s, a hasty restart of a hiking path which would destabilise the economy. Secondly, overtightening can be offset by cutting swiftly rates or using other tools, as shown at the beginning of the pandemic. The nasty surprises on inflation over the last months forced the Fed to a steeper path of hiking than those expected in the summer, ad this is clearly reducing the possibility of achieving a soft landing. Almost all term spreads are inverted, even the near term forward spared preferred by the Fed, even though Powell said (not very convincingly) that this is due to expectations of a quick reduction of inflation rather than just recession fears. We have revised down our growth forecast for 2023 to just 0.2% with a GDP contraction in the first half of the year.



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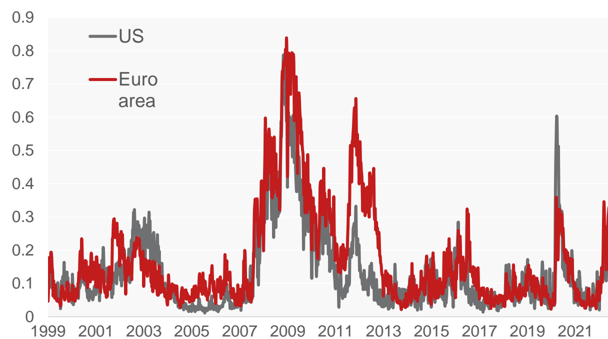

Source:ECB, Datastream, GIAM

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