Monthly Fixed Income Insight

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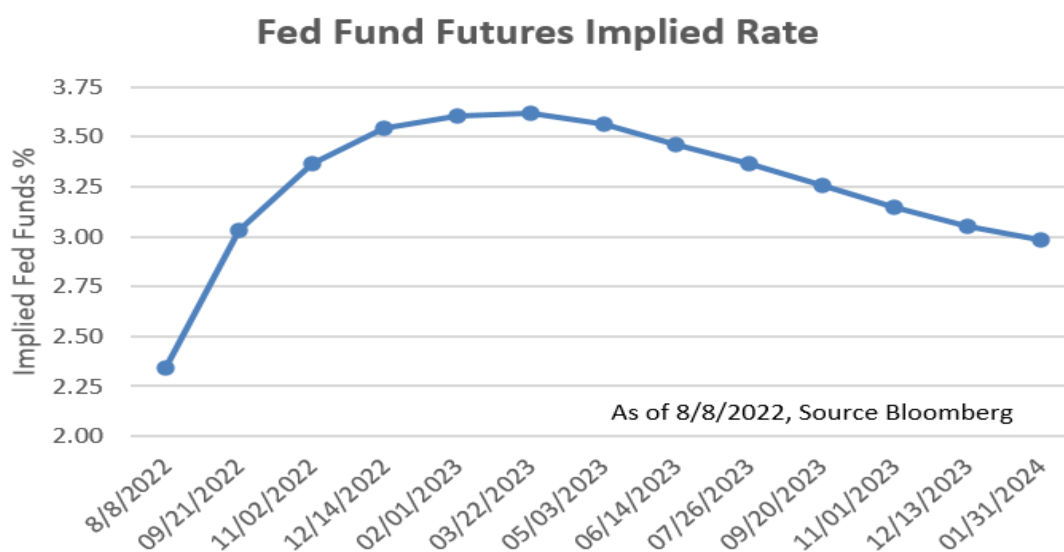
Choosing sides on the Federal Reserve pivot

Despite push back from Federal Reserve officials, the markets still expect the Fed to pivot from hiking to cutting short-term rates by the middle of 2023. From the graph below, the market is pricing a peak for the federal funds rate of 3.62% in March of 2023, quickly followed by interest rate cuts in the second half, with rates ending the year at 3.05%. There are two sides to the argument on when the Fed will pivot policy. One camp believes the Fed will pivot to easier policy in the face of slowing economic growth and the risk of recession, despite falling short of its 2.0% inflation target. The other side sees the Fed keeping policy tight at all costs to combat persistent inflation and to maintain inflation fighting credibility.



Inflation remains public enemy number one

Recent economic data has rapidly swung the pendulum between inflation fears and recession risks. Second quarter GDP declined 0.9%, following the 1.6% decline in the first quarter, leading to debates on whether the economy was already in a recession. Next, the July payrolls report showed employment was not only strong but strengthening as the economy added 528,000 new jobs and the unemployment rate fell to a new low not seen since the 1960s. This pushed market participants from recession fears to worries over a potential inflationary wage-price spiral. Lastly, this week's inflation report provided significant relief to the markets as price pressures moderated and investors considered the possibility that the long-awaited peak in the rate of inflation has passed.

Despite the wild roller-coaster ride in economic data, at DSAM, we still see a pause rather than a pivot from the Federal Reserve. We expect the Fed to raise rates by 1.25% this year to a rate of 3.75% and then hold rates steady for the balance of 2023.

In our view, inflation pressures outside the volatile food and energy segment will remain "sticky", especially in the important shelter category and the service sectors. Rents tend to move slowly, and higher prices are already in the housing pipeline. Service inflation could also remain elevated as consumers shift away from goods purchases to services. Under this scenario, we would expect some modest improvement in the core CPI, but not enough for the Fed to declare victory and switch to an easing policy mode.

The Fed does maintain a dual mandate for stable inflation and maximum employment; but for now, with inflation at a 40-year high, the full employment commitment is out the window. Following the July FOMC meeting, Chairman Powell said the Fed is “strongly committed” to reducing inflation and that could come with a cost to general economic growth and the labor market. Inflation clearly represents the Federal Reserve’s primary focus even at the risk of pushing the economy into a recession.

Lastly, with some improvement in the direction of inflation and since monetary policy works on a lag, the Fed may choose to pause at some point in the near future to ascertain the impact of the rapid rate increases on the economy. The Fed is not only fighting an inflation battle but also to regain its credibility. The Fed clearly lost credibility by sticking with the “transitory” inflation narrative and waiting too late to raise rates; it can ill afford to cut rates prematurely only to reverse course later if inflation reemerges.

Past performance is no guarantee of future results.

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