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9/30/22 Focal Point: Will the Markets Call the Fed's Raise and Hold Bluff?

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Our 6/30/22 Focal Point: Hard or Soft Landing discusses the first debate, which is still ongoing, on the depth of the economic slowdown. While this is ongoing, the question is now moving to how long the Fed will keep tightening policy in the face of a slowing economy.

The Fed's new catch phrase is now "raise and hold". It was introduced at its annual conference in Jackson Hole during August 2022. For a large portion of 2022, markets have been pricing the Fed to reach a rate peak in early 2023, but have then been pricing rate cuts to start by the end of 2023, reflected by bonds due in late 2023 yielding less than the Fed's target rate in March of 2023. The Fed did not like this, so adopted the "raise and hold" wording to keep interest rates near its terminal rate throughout 2023.

Here's the catch: "Raise and Hold" is about projecting where Fed policy will be a year from now. The Fed often introduces new concepts at Jackson Hole. A year ago, in August 2021 (Jackson Hole '21), we were getting a Fed mantra of "transitory" inflation. The Fed was thinking about tapering QE but was going slow, because the Delta and Omicron variants were still weighing on activity, and concern an early start to rate hikes could limit the ongoing economic recovery. A year before that, in August 2020, Powell's Jackson Hole speech introduced a new policy framework of not hiking rates until there were actual signs of inflation. In both 2020 and 2021, it was trying to support the economy and did not want the markets pricing rate hikes too soon, and so was trying to keep rates from rising too soon.

The 2020 and 2021 policy stances were seen as suggesting a certain Fed policy path, but it later deviated. This doesn't mean the Fed is bad at making forecasts. Nor does it mean it's bad for the Fed to shift its policy as the economy changes. But what it does mean is that the Fed is no better or worse at forecasting the economy and policy than anyone else. And often their "projected policy" is more about controlling the market and economy in the moment the forecast is given, not predicting where things will be.

Markets know monetary policy acts with a lag, and CPI and unemployment are lagging, not leading, indicators. They also see the rapid rate hikes, the rapid rise in rates in general (US and globally) and are wary of the impact that todays' actions will have on the economy in 6 months. For the Fed to truly pivot in the face of a slowing economy and/or market stress, it needs to start seeing some progress on the CPI data. It's not ideal, but they have painted themselves into this corner.

Until the Fed pivots and shows signs of adjusting, "going too far" is a risk. This could mean a recession, a foreign exchange crisis, or other issue, such as the UK's unfolding budget issue.

Will market uncertainty and volatility ultimately cause a risk to financial stability, and cause the Fed to act? Will the Fed really raise and hold, or are markets right that by mid-2023, actions already taken will have slowed inflation and the economy enough to allow the Fed to lower rates? *Will the Markets Call the Fed's Raise and Hold Bluff?* The markets will be focused on this as 2022 comes to a close. Once the Fed shows a sign of a policy pivot, the markets themselves can pivot to gauging the depth of the downturn and starting to look past it. Until that point, concern over the timing and depth of the slowdown will keep a lid on the market.