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BULLETIN: Fed Actions & Market Correction

June 17, 2022

OVERVIEW

As we anticipated, this year has continued to be a challenging transition back to a normal economy.

In many ways, this remains a "healthy correction" as the Federal Reserve Bank is removing the excess liquidity that they put into the system to support the economy during C-19. This will bring the economy - and asset values - back into balance for longer term stability and economic growth.

The war in Europe, reduced energy production and lingering supply chain issues have complicated the situation with additional unanticipated inflation. The Fed now is now trying to "thread the needle" between tamping inflation down while not driving the economy into a recession.

In historical context, this correction is unusual in that it is not about underlying economic weakness that caused the correction - but economic excess that has resulted in labor shortages and price escalations. Therefore, the markets right now are ALL ABOUT THE FED and its policies.

The market is processing the information and will remain volatile until the central bank is done with its major adjustments over the next several weeks.

THE POLICY DETAILS

The Fed on Wednesday raised the Fed Funds rate by 0.75% to a new target range of 1.50% to 1.75%. In addition, it affirmed its plan to reduce its balance sheet (QT) on the schedule stated last month.

At the follow-on press conference, Chair Powell's opening remarks said that the labor market is extremely tight and inflation is much too high, a clear message that interest rate hikes will continue until there is more meaningful relief on both fronts. Powell noted that food and energy prices have caused the Fed to raise its inflation forecast and with pressures continuing to the upside.

Powell said the Fed is strongly committed to returning inflation back to the Fed's 2% target. Powell noted that 0.75% hikes are extremely uncommon but either a 0.5% or 0.75% rate increase would be appropriate at its next meeting in late July. He also stated that inflation is likely to remain elevated in the short term and the Fed would like to see demand moderate, another indication from the Fed that more interest rate hikes are required to help inflation ease.

Wall Street Journal, June 15, 2022
Bloomberg, June 15, 2022

What changed the FOMC mindset to do a 0.75% rate hike rather than 0.5% was last week's CPI reading of 8.6% over the past year and the University of Michigan consumer survey showing that longer term inflation expectations are still going higher. As a result, a more aggressive rate hike action was made.

The updated FOMC forecast is for Fed Funds to be 3.4% by the end of 2022, or 2X the current level after Wednesday's 0.75% increase. If the Fed stayed on its rate hike path for the rest of the year, that is 4 more interest rate hikes at each remaining Fed meeting.

Outsized price reactions are typical on a Fed policy decision day (stocks have rallied after the past 3 meetings of rate increases, only to falter), but there was nothing on Wednesday that should materially reverse the recent state of stock prices or yields based on this news. In fact, today, U.S. stocks gave back all of yesterday's gain and declined 3.5%. Year to date, the S&P 500 Index is now down 22.5% year to date. Bond returns are also very poor, down 11.4% year to date.

For now, inflation is what really matters and it is still a problem and when it finally breaks is when downside market pressures most likely will ease. Economic data is slowing quickly (housing in particular) and the odds of a recession are increasing daily as the Fed hikes interest rates to break inflation. It is not a good setup for risk assets.

July 13th is the June CPI reading. Our view is that if the June CPI reading is not below the May CPI reading of 8.6% on a trailing 12-month basis, the Fed is more likely to do 0.75% than 0.5% when it makes its next policy decision on July 27th.

KEY TAKE AWAYS

Expect continued volatility until The Fed is done with their rate adjustments - and they attempt to manage wage and price inflation.

The market usually "overshoots" in both directions - so stay the course in a sensible asset allocation for your long-term goals - and avoid trying to time the markets.

If you would like us to call you about the current market conditions – please send us a note and we will contact you shortly. We are always here to provide additional guidance in between our regularly scheduled meetings.

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