July 28, 2022

Fed Flash: A second 75bp hike

- **On Wednesday, the Fed delivered a second 75bp rate hike, in line with forward guidance**
- **Dovish undertones in the Fed's statement suggested the pace of hiking could slow**

Continuing its battle with 40-year-high inflation, the Federal Reserve has delivered a second 75 bp rate hike, as expected. This lifted the target range to 2.25% - 2.50%, in line with the Fed's long-run "neutral" rate – considered to be that at which rates are neither stimulating nor stifling economic growth. It is also the highest level since December 2018, when the Fed completed its last hiking cycle.

Despite the fact that "recent indicators of spending and production have softened", Chair Powell made clear that more tightening is appropriate as inflation remains high and the labour market still strong. The US CPI continued its relentless rise in June, reaching 9.1%. In its statement, the Fed added food prices to the worries over oil and "broader" price pressures:

"Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher food and energy prices, and broader price pressures"

In a slightly more dovish tone, Powell added that monetary policy kicks in with a lag and that the full effects of its prior hikes this year are yet to be felt. Additionally, he said "unusual" moves of this size (i.e. 75bp) should not be viewed as the norm (until last month, the Fed had not hiked by such a magnitude since 1994) and that “at some point”, the Committee would begin to raise rates at a slower pace. The size of hikes from here will be data dependent and judged on a meeting-by-meeting basis (echoing the ECB’s July message). If data continues to soften as it is doing now in the eight weeks to the September meeting, we think a 50bp hike is more likely.

Today, the US Q2 GDP print will be released and according to the Atlanta Fed GDPNow tracker, it could come in at -1.2%. This would mean two consecutive quarters of negative growth for the US – fitting some common definitions of a “technical” recession. Powell pushed back on this idea stating, “The US is not currently in a recession, and the reason is that there are just too many areas of the economy that are performing too well.” Pointing to strong jobs growth, he said, “it doesn't make sense that the economy would be in a recession with this kind of thing happening."

After this reassurance from Powell and the possibility of slower hikes from here on out, US stocks closed higher (the S&P 500 up by more than 2.5%, the Dow by around 1.4% and the Nasdaq by 4%). The yield on two-year Treasuries, which are sensitive to policy, declined to below 3% and the dollar softened.

In all, market attention is turning to the end of this cycle. This second 75bp hike from the Federal Reserve will further tame inflation expectations, which have really come down markedly in the past months. While the recent 9.1% inflation print is noteworthy, it is not pivotal. Inflation expectations matter more. The 2yr inflation breakeven is now down to the 3% area, having been at 4.5% in mid-June (and 5% in March).

Central bank benchmark rate tracker

	Jan 22	Feb 22	March 22	April 22	May 22	June 22	July 22
US	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.75-1.00	1.50-1.75	2.25-2.50
ECB	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	0.00
UK	0.25	0.50	0.75	0.75	1.00	1.25	1.25
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
China	3.70	3.70	3.70	3.70	3.70	3.70	3.70