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The Fed's tightening campaign is starting to work

In its offensive against stickier-than-expected inflation, the US Federal Reserve began its hiking campaign back in March 2022. In total, it has now increased its key rate by 375 basis points in what has been the fastest rate hike cycle in history. However, it takes time for the cumulative effect of tighter monetary policy to work its way through the economy and only now, are we starting to see convincing evidence that tighter policy is having the desired effect.

By raising interest rates, the Fed aims to temper elevated demand which has pushed up corporate activity and prices. The moderation in demand has occurred at varying speeds across sectors. In those that are highly sensitive to interest rates, such as housing, recession is already nigh. However, in other sectors, lags in transmission mean that tighter policy is only starting to have a visible effect. This helps explain why earnings expectations, which have been remarkably resilient through most of the year, have started to deteriorate. According to FactSet, on September 30, the estimated earnings growth rate for the S&P 500 in Q4 2022 was 3.9%.

Today, the estimated earnings decline is -1.0%. Anticipated margin compression squares with anecdotal evidence from PMI surveys suggesting corporate and consumer demand is waning – especially for goods.

What we have seen play out so far tallies with the classic inflation cycle which normally sees commodity prices soften first, then goods. Usually, services are next in line and then ultimately wages.

The US labour market has been problematic for the Fed, the one stubborn area where, until now, policy seemed to do little to rebalance the supply and demand for workers with unemployment hovering near a 50-year low. However, with tighter financial conditions hurting cyclical demand, very faint cracks are starting to appear. Though private employers continued to hire at a resilient pace last month (+261k jobs added), it was the slowest pace since December 2020, and micro data tells us layoffs are starting to pick up – for example, Meta just announced 11k layoffs. Nonetheless, the labour market is still "hot" with the current ratio of job openings to job seekers at 1:9 versus 1:2 before the pandemic. A tight labour market typically pushes up wages – one of the stickier inflation drivers.

Overall headline inflation has also been trending downwards, hitting in 7.7% October, quite a bit below June's peak of 9.1%. But the Fed is not out of the woods yet – it is still more than three times the Fed's 2% target and it has broadened out. As such, the Fed has to continue to make progress in bringing it down. Failure to do so would likely lead to a de-anchoring of inflation expectations and a potential price spiral.

This leaves the Fed in quite a predicament. It has to decide how much tightening is still appropriate while previous actions continue percolating through the real economy. If it doesn't tread carefully it risks overtightening, increasing the probability of a "hard landing" for the economy. It is therefore likely that the Fed takes its foot off the gas, opting to continue tightening, albeit with a "slower for longer" approach.

Such a shift would have implications beyond the US economy. The Fed is the playmaker with regard to tightening, with other central banks like the ECB somewhat forced to keep pace and prevent widening policy differentials which will weaken their currencies against the dollar and stoke inflation further. A slower Fed would likely inspire a collective sigh of relief from other central banks around the world whose economies are looking a lot less sturdy than that of the US.

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