

# Federal Reserve: It ain't over 'til it's over

## Still fixated on high inflation

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FLASH NOTE

### SUMMARY

- The Federal Reserve (Fed) is likely to once again deliver a hefty 75 basis points rate hike at its policy meeting on 2 November, pushing the fed funds target rate range to 3.75-4.0%.
- The Fed is unlikely to make any change to its quantitative tightening programme, which continues apace in the background.
- Inflation-fighting is likely to remain the Fed's priority: we think it is illusory to expect Fed chairman Jerome Powell to signal a near-term end to tightening.
- A major thorn in the side of the Fed right now are consumers' inflation expectations, which remain stubbornly high. Hence, even if Powell might point to slower rate hikes ahead, he is unlikely to lower his guard entirely.

### DECREASING LIKELIHOOD OF A 'SOFT LANDING'

Despite growing political pressure (including open letters to chairman Powell from some Democratic senators) and despite a deterioration in some leading economic indicators, we expect the Fed to **stick to prioritising inflation-fighting** when it announces its latest rate hike this week. We believe the Fed will announce another 75 bp increase in the Fed funds rate and that it will leave its quantitative tightening programme unchanged despite growing liquidity worries in the US Treasuries market.

**Core CPI inflation data remain the Fed's alpha and omega.** The problem for the Fed is that core consumer inflation came in at a lofty annual rate of 6.6% in September (and headline inflation at 8.2%) and proving to be sticky.

Apart from inflation, the Fed is paying particular attention to monthly employment gains, which are proving resilient. The unemployment rate was a very low 3.5% in September, even though some leading indicators point to a rise in 2023.

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**The stubbornness of consumers' inflation expectations is a particular worry for the Fed.** The University of Michigan's survey of one-year inflation expectations was a still-high 5.0% in October, feeding the Fed's fears that **inflation may become entrenched**, as in the 1970s. This is why **we think Powell is unlikely to commit to an end to Fed tightening for now.**

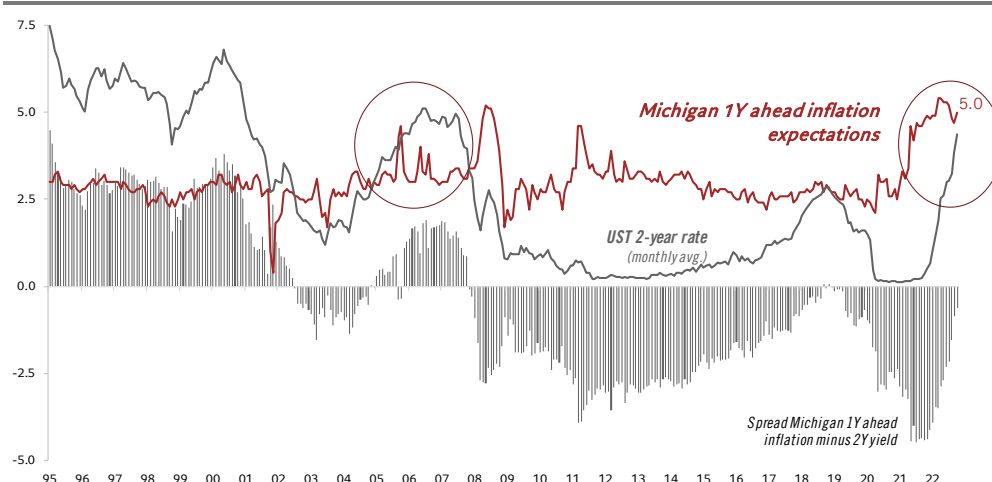
The sharp deterioration in the US housing market is unlikely to be central to the Fed's deliberations, as some Fed members believe housing needs some deflating after the post-covid boom. And the slowdown in housing could have the welcome effect of cooling rental inflation, a major factor in recent price rises in the US.

Money markets are currently pricing in a peak at almost 5% (4.95% to be precise) for the Fed funds rate by May 2023— well above the terminal rate of 4.6% indicated by the Fed in September.

The Fed's new rate projections will be released at the Federal Open Market Committee meeting on 14 December (our own 2023 scenario for Fed policy is currently being finalised).

Overall, we think it illusory to believe that Powell will signal a near-term end to tightening. He could hint at a slower pace of rate hikes but nothing beyond that in light of recent inflation data. The risk of a policy mistake (i.e. the risk of over-tightening), is high, especially in an environment of **high debt and shrinking market liquidity**. A crucial risk is that the housing market could suffer more from the sharp rise in mortgage rates than the Fed anticipates, with potential spillovers to the rest of the economy, even though our central scenario is still that we do not see US mortgages sparking another global financial crisis like in 2008. We worry about the long lags in monetary policy's impact on growth: **The Fed's chances of achieving a soft landing in 2023 are narrowing given the sharp tightening that has already occurred, with more still to come.**

**Chart 1: Consumers' inflation expectations remain high**



Source: PWM CIO Office & Market Research, Bloomberg Finance LP, 31 October 2022

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