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Weekly Market Flash

A Confident Fed Contemplates an Uncertain Economy

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Fed Chairman Jay Powell is happiest when adjectives like "boring" and "utterly predictable" get appended to his name. He will not have been displeased with the takeaways from this week's Federal Open Market Committee (FOMC) meeting. This week may have set a new high water mark for frequency of use of the phrase "no surprises" in financial media outlets. All the more remarkable is that this sanguine groupthink happened even as the actual content of the FOMC and its attendant documents (notably the infamous dot-plot tabulating the outlooks of the Committee's members on economic and interest rate trends) trended notably more hawkish. Well played, Chairman.

Three by Twenty-Three

The most closely-watched dot-plot is the interest rate expectations for the eighteen FOMC participants. For much of the time since the Fed first took action to shore up the economy after the pandemic started, the time line for lifting off the current zero lower bound Fed funds target has been 2023. Now, however, a full half of the FOMC members expect that rates will begin to go up in 2022, and a majority expect there will have been at least three consecutive rate hikes by the end of 2023. That is a more hawkish take than previous projections.

Before anything happens with interest rates, though, the first order of business is doing away with the current program of Fed purchases of $120 billion of Treasuries and mortgage-backed securities each month. Powell expressed confidence that the time is nigh to set a calendar to that winding-down, thus setting clear expectations that this will happen in November (the calendar, that is, with a fixed date for first reductions) with a likely full winding-down of the program by the middle of next year. Here, he stated explicitly that the so-called "substantial further progress" test, meaning the economy's clear path to average inflation of two percent and full employment, has already been met.

This was the clearest vote of confidence the Fed has yet expressed on the prospects for full economic recovery in the wake of the pandemic. It probably goes a long way to explaining why asset markets have been generally upbeat since the meeting on Wednesday, brushing aside concerns earlier in the week about the Evergrande debt crisis and other troubling data points.

About That Economy…

Behind the general feel-good vibe from the FOMC meeting, though, there are some reasons to hold one's optimism in check. For one thing, that same Summary of Economic Projections with the interest rate dot-plots also reflected a change in sentiment among FOMC participants about near-term economic growth, which they think will be lower than the previous estimates released in June, and about both headline and core inflation, which they think will be higher. The acceleration of the interest rate hike calendar may reflect a somewhat more heightened level of concern among some of the participants about the potential for inflation to be stickier than the prevailing Fed consensus that it is a temporary phenomenon.

A world in which the central bank has to raise rates, not because of strong economic growth but because of persistently higher inflation that would likely steepen the yield curve well beyond its current shape, summons the dreaded sector of stagflation, that bugaboo of the late 1970s. Right now, the key potential

sources of stagflation risk lie in three areas: supply-side problems including sky-high goods transportation costs and dysfunctional supply chains; demand-side problems from the lingering effects of Covid's delta variant and a slowdown in China; and a shortage of labor. Right now there is still a better case to make that these problems get worked out without triggering 1970s-stye stagflation. But if expectations of higher prices and higher wages fall into a positive-reinforcement spiral, there is more reason to doubt they will simply go away on their own.

The Fed's problem with stagflation is that it can't simultaneously solve both sides of its twin mandates of stable prices and full employment. Right now there is not much evidence that this scenario is having any influence on asset prices. High yield bonds, for one, are currently producing average yields in the range of four percent – i.e., not too far off where inflation currently sits. That dynamic is only sustainable if today's inflation truly is a quickly passing phenomenon. It will behoove us to pay close attention to the frothy market for risky debt – of which there is an abundance at present. It may turn out to be the canary in the coal mine.

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