Caron's Corner Transcript - 12.14.2022

Fed Recap: No Country for Old Doves, Just Hawks, No Chickens

- No surprise, the Fed hiked 50 basis points from 4 - 4.5%, but said "more work needs to be done."
- Big, hawkish surprise though, the Fed Dot Plot, i.e. the median dot for 2023, increased from 4.6% from the last meeting to 5.1%.
- This suggests the Fed will hike toward 5.25% in 2023 - and maybe higher!
- The bottom line is that the Fed is worried about inflation not only falling enough but remaining anchored near target levels by 2024.

Jim Caron: We just had the Fed meeting and we're just going to give a recap of that right now. What I'd like to call this recap is "no country for old doves, just hawks, no chickens." The reason I say that is because there was nothing dovish in today's Fed meeting just hawkish. At a point where some of the markets were thinking that the Fed may have become dovish, this is an important counterpoint. So betting that financial conditions will continue to ease, which means easing the financial conditions, which would be higher equity prices, tighter credit spreads and lower rates is really akin to believing that the Fed will fail at bringing down inflation or that they will chicken out and stop hiking prematurely to keep the unemployment rate low. Now, there was nothing to suggest this to be the case in in today's meeting, in fact quite the opposite. So let me get into my summary of key takeaways.

The first one is clearly the Fed hike, 50 basis points from a 4% policy rate to 4.5%, where the Fed said "more work needs to be done." Look, this was as expected. The big surprise came in the dot plot, the median dot for 2023 increased from the last meeting in September, which showed a 4.6% rate. That was a 4.6% terminal rate, a rate between 4.5 and 4.75%. That was where people thought or based on the Fed's expectations or their summary of economic projections, where they were projecting stopping or having a terminal Fed funds rate. Now, what they said at this meeting was that that dot plot moved up to 5.1% which means that the terminal rate is somewhere between 5 and 5.25%. That's the big surprise in today's meeting that they just didn't go from 4.6% rate to 5%, but to 5.1%, meaning that the terminal policy rate may come in between 5 and 5.25% towards the end of the first quarter or beginning of the second in 2023. Actually, maybe even higher, and the Fed is maintaining that they're going to keep rates high in 2023, meaning no cuts based on their projections despite what the markets actually pricing that we went through that in the last Caron's Corner on Monday. But again, projections versus expectations versus pricing are two totally different things. But this is what the Fed is telling us. They have no plans to cut.

So the key next question becomes where and when will the Fed be done hiking? In other words where and when do we reach that terminal rate? The early signal from this meeting is a 50 basis point hike again in February and a 25 basis point hike in March, and that gets the terminal rate to that 5 to 5.25% level. But there's upside risk given the dispersion in the dots from Fed forecasters meaning that many Fed forecasters give their expectation of where that terminal rate may be and those become the dots. All of that was skewed to the upside, some thinking as high as even 5.6% as the terminal rate, getting between the 5.5 and 5.75% rate. There was unanimous consensus that rates are moving higher so the Fed may end hiking in March, or they could go 25 basis points in February, 25 in March and then 25 again in early Q2, and that could still get them up to 5.25%. Or they move even higher if we believe in

that dispersion of dots, but it depends on how the Feds sees the path of inflation. So let's talk about that.

For starters there was no acknowledgement of the recent November drop in CPI inflation which came out Tuesday, almost as if it never even happened. No mention of it, and this is important information because the Fed is really looking past this. So even though there was a good drop in inflation and people thought the Fed was becoming dovish but the Fed isn't didn't even make any mention of this and I think that's important information. It indicates to me that the Fed is not satisfied with the drop, that they saw in the recent CPI inflation release because it came mainly from the goods sector. Here we go again. We're going to talk about the goods sector versus the service sector, and what's more concerning to the Fed is service sector inflation. Core services accelerated to 6.8% from 6.7, moving in the wrong direction. Note that the biggest cost for the service sector is labor costs, and labor costs have been growing a lot and this is the key linkage to make towards wage inflation. Again as service sector inflation moves higher, wage inflation moves higher and this creates an issue. The Feds sees, based on their recent forecast, that core PCE inflation will reach 3.5% in 2023, which is above their target of 2 to 2.5% and that it may not reach target inflation of 2 to 2.5% target inflation range until 2024.

In other words, what the Fed is telling us is that we're going to be above target inflation in 2023, and we may only barely get to the top end of the target range in 2024. This tells me that they're a little bit worried and it also tells me that they think inflation is likely to be sticky. The Fed seems concerned about the risk of wage inflation and a wage/price spiral inflation developing. This is a condition where you have higher service prices based on higher wage prices and it just keeps spiraling on and on. As longer lasting inflation expectations become ingrained, it's really, really hard to break that spiral. This was the mistake in the early 1980s and that's why inflation got way out of hand and Volker had to do some pretty big things to make that stop happening. Seemingly the Fed is worried about not tightening enough and allowing for inflation to resurge later in 2023 and I think this is a risk that is underappreciated by the markets. The Fed is more worried about a resurgence in inflation in late 2023 as opposed to just inflation coming down so they're going to do whatever they can do to make sure that doesn't happen and that's something that we should, I'll realize it and really take to heart.

As a Fed sees it, it's better to overtighten then under tighten because the cost of a resurgence in inflation would require that they hike even more, which will harm asset prices in the economy and the labor market later on, so better to take that hard medicine now as opposed to taking it later because it will be much worse. With that the Fed also made a projection in terms of growth, where the Fed projects in 2023 is that we're going to get 0.5% GDP growth so we're going to be bouncing right along the lines of recession. That may then start to rise again towards 1.6% in 2024. These are Fed forecasts and that's slowing growth that's required to bring inflation down towards target. Then we bring in the labor market and this is where things get a little bit contentious and where there's probably a lot more disagreement with Fed forecasts.

The Fed increased their unemployment rate forecast from 4.4 to 4.6% in both 2023 and 2024. Now that's still a very low level of inflation and many economists believe that the Fed will need to adopt a policy to hike rates even more to get that unemployment rate even higher in order to lower wage inflation from current levels to around 3%, which is much more consistent with a target inflation that

comes in around 2.5%. So I think the Fed is being overly optimistic in terms of how strong the labor market may be. Also getting inflation down to target, well, many people think that there has to be much more harm done to the labor market in order for that wage inflation to drop and inflation overall to come down. So reading between the lines, perhaps this is why the dispersion and the dot plots in the dot plot forecasts are skewed to the upside of 5.25%. Maybe the Fed themselves don't fully believe that a policy rate hike to 5.25% will be enough to increase the unemployment rate and also bring down wage inflation. Again, I'm just trying to read between the lines and give you my interpretation.

Let me give you the bottom line here. The Fed is worried about inflation not only falling enough, but remaining anchored near target levels by 2024. They clearly communicated and illustrated that there is upside to the 5.25% terminal rate as indicated by the 2023 dot and the surrounding dispersion of dots in there dot plot forecast. It would seem that the loosening of financial conditions that we're seeing today, namely tighter credit spreads, lower yields and higher equity prices, is inconsistent with Fed policy and what they're trying to accomplish. This needs to be addressed and is a negative for asset prices, which would mean that yields would need to rise and credit spreads would have to widen, and you'd have to get weaker equities and a stronger dollar in order to tighten financial conditions.

How do we square bond yields today, which have come down a lot and are still low, in terms of what the market's pricing for the Fed? Well, we think there are a lot of technical factors that are at work, namely fixed income investors are underweight their duration benchmarks and they've been short their duration benchmark for most of 2022. And with the recent drop in yields, they've been dragged and forced into the markets to buy bonds to just get back to neutral relative to their benchmarks. Perhaps this may persist, this buying of bonds, and support from fixed income may persist into year end. But, in January, all of these bond investors will have to contend with the fact that policy rates may be going up towards 5.25%, possibly higher, and the Fed doesn't seem to be giving up on tightening policy as a means to contain inflation. They remain hawkish and unlikely to chicken out anytime soon.

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