Advisory Blog

Timely insights on the issues that matter most to advisors and their clients

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Fed | Inflation | Markets and Economy | Rates

Fed Signals Possible Slowdown in Rate Hikes as Economy Cools

By: Eric Stein, CFA | July 28, 2022

Boston - As expected, the Federal Open Market Committee (FOMC) raised its fed funds target by 75 basis points (bps) to 2.5% at its meeting on July 27. But the big news came from the commentary of Fed Chair Jerome Powell, which was taken by the market as quite dovish.

Powell indicated that after the latest action, which followed a comparable 75-bps hike in June, "at some point it will be appropriate to slow down." He noted that the fed funds rate, at 2.5%, is at a level that the Fed considers "neutral" — that is, neither tight nor loose.

This comment signals that we are in a new phase where the size of future rate hikes will be data dependent and determined on a meeting-by-meeting basis. Powell said the Fed "would not provide the kind of clear guidance that we had provided on the way to neutral."

Powell referenced the June "dot plot," which anticipates another 100 bps in hikes by the end of the year. That is consistent with increases in the fed funds rate of 50 bps in September and 25 bps in the final two meetings of the year, which would bring the fed funds rate to 3.5%. He also mentioned hikes projected in the dot plot in 2023 — this could be Powell's way of managing the market's expectations for a near-term easing scenario.

Two-way risk

I think the market still believes there is two-way risk. If inflation continues to surprise on the upside, the Fed could go another 75 bps or even 100 bps at the next meeting. But I don't think this is the base case.

High-frequency data on inflation, like commodity prices and inflation expectations, are cooling. In the "real economy," signs of a slowdown are evident, as Powell mentioned. Right after the meeting, on July 28, the latest GDP release showed the U.S. economy slowed by an annualized real rate of 0.9% in the second quarter, following a decline of 1.6% in the first quarter — numbers that enter recession territory.

Market reaction to dovish implications

The markets reacted to Powell's comments on July 27 with a big risk-on rally: Equities were up sharply, the yield curve steepened and the U.S. dollar was broadly weaker. This is very consistent with investors looking past the 75-bps hike, which was fairly well priced in, to the implications of a more dovish policy implemented on a meeting-by-meeting basis.

When there is a big immediate rally sparked by the outcome of Fed meetings, we often see reversals on the following day. We will see how the market digests the latest soft GDP figures on July 28, and whether it reinforces the likelihood of a more dovish policy.

Bottom line: After two big 75-bps rate hikes, the Fed appears to have achieved its goal of trying to get ahead of — or at least not too far behind — the curve of inflation, and policymakers seem prepared to raise rates at a slower pace. Now, with less guidance from the Fed, we are entering a period when data on inflation and growth will be scrutinized for clues even more closely.

For more insights on navigating higher inflation, please visit the Inflation Resource Center

Eric Stein, CFA
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