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The Fed left standing alone

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Central banks have been on overdrive to clamp down on inflation. So far we have witnessed the largest and fastest tightening in a century, bringing bond yields back to near 20-year highs. With a stronger dollar, high interest rates and quantitative tightening all at once we are witnessing history in the making. This trifecta of circumstances is a first for the world's largest central bank, the Federal Reserve, since its establishment in 1913.

The International Monetary Fund (IMF) warned of a worsening outlook for the global economy, cautioning that ongoing efforts to curb the highest inflation in decades may add to the damage already caused by the war in Ukraine and China's slowdown in economic growth. The IMF cut its forecast for global growth next year, adding that it sees a 25% probability that growth will slow to less than 2%. According to the IMF, the risk of policy miscalculation has risen sharply as growth remains fragile and markets show signs of stress. It stated "about one third of the global economy risks contracting next year" with the US, European Union and China all continuing to stall. The IMF sees greater risk from central banks doing too little rather than too much amid persistent price pressures, a mistake that would cost them credibility and increase the eventual cost to bring prices under control.

Recently, major central banks have neared a crossroads as some have floated a sense of dovishness, led first by the Bank of Canada which delivered a lower-than-expected 50 basis points (bps) rate hike. This was followed by the European Central Bank where policymakers delivered a second 75 bps hike but signalled a reluctance to state explicitly that more increases are in the pipeline. Despite still elevated inflationary pressures, officials have stressed how difficult it is to gauge the appropriate terminal level of rates, making them cautious about taking rates into economically restrictive territory. The Bank of England was even more affirmative by stating that if policy rates did rise as high as markets are expecting, a two-year long recession could be the result. Therefore, by pushing back firmly against the market it set a firmly dovish tone even though it delivered a 75 bps rate hike which was the biggest in over 30 years. The Fed on the other hand continues to warn the market that rates could go higher than expected, which has left it standing on its own.

In the last Fed meeting, the Fed chair warned that they still have a long way to go in their quest to tame soaring prices and pointed to economic reports suggesting that it was yet to make a dent in inflation. The Fed indicated that it may ultimately move to higher levels than expected at the time of the September meeting. Data incoming since their last meeting suggest that the ultimate level of interest rates will be higher than previously expected. The Fed chair emphasised that it was very premature to be thinking about a Fed pivot. Also echoing the same sentiments as the IMF, the Fed chair highlighted that the risks of managing inflation are asymmetric; if the Fed raises rates into restrictive territory, it can cut rates later to support growth but if it doesn't tighten enough, the costs to manage entrenched inflation will be overwhelming.

Investors are concerned about whether the Fed's tightening will trigger financial instability. The impact of the Fed's monetary policy tightening will be felt globally, with the dollar's strength against emerging markets currencies adding to inflation and debt pressures. The recent liquidity issues faced by UK pensions funds and concerns about the health of some European banks have led to speculation that the Fed's interest rate hikes will trigger some form of financial instability which, could turn what might otherwise be a mild recession into

something far worse. Given the massive surge in borrowing costs faced by businesses and households, this risk cannot be ignored.

The Fed will be watching the data and evolving market conditions before introducing any significant rate pauses. A downshift in the pace of tightening, and eventually a pause, will therefore require clear evidence of decelerating inflation and a deteriorating labour market for some consecutive months at least. The labour market has continued to hold up better than expected and with wage growth still too hot for the Fed, there is little to suggest that officials will drop their hawkish tone any time soon. Even though inflation numbers released in November showed softer numbers than the market anticipated, the Personal Consumption Expenditures to be released on December 1, 2022 will be the last piece of data before the Fed’s December meeting. This is a more preferred measurement of inflation as it is broader and captures changes in consumer behaviour. Global macro events will also continue be considered, including Russia's war with Ukraine and the effects of China's zero-COVID policy.

There is a risk that a stormy global economy could spur investors to safe-haven assets such as US Treasuries, pushing the dollar even higher and pressuring debt in emerging and developing nations. Investors need to consider a number of personal and macro-economic factors. At a personal level these will include tolerance to risk, income needs, and the nature of currently owned assets. From a macro-economic viewpoint, thought should be given to the prospect of further interest rate and inflation increases, and the broad economic outlook in general. Investors should stay vigilant and not get distracted by any Fed moves to the side-lines if there are still very real costs and risks attached to higher costs of borrowing for households and businesses.

Sources
BCA Research & Bloomberg Economics
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