THE FED, INFLATION, AND MARKETS
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EAGLE Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

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THE FED TIGHTENS FINANCIAL CONDITIONS What's Next

With last week's 75-basis point interest rate hike, the U.S. Federal Reserve's objectives are beginning to manifest, says James Camp, CFA, Managing Director of Fixed Income and Strategic Income at Eagle Asset Management.

"While aggregate inflation baskets like the Consumer Price Index have shown little sign of cooling, the Fed has aggressively tightened financial conditions," Camp says. "Long-term rates are meaningfully higher, equity prices are sharply lower, and credit spreads have widened. There is a lag to monetary policy, but these changes will ultimately curb demand."

Here are a few key implications and considerations for investors:

Demand destruction: A pre-condition for slowing inflation

Cross-asset class volatility is likely to persist as long as the Fed continues to normalize monetary policy, Camp says. "This is part and parcel of what the Fed is trying to achieve. Lower asset prices are affecting consumer psychology and the propensity to spend. Demand destruction is a precondition for slowing inflationary pressures. The Fed desperately needs to regain control over the inflation narrative, and recent inflation expectations survey data suggest it is losing this battle."

While the cross-asset class volatility is painful for investors, it is consistent with regime changes, particularly those where deleveraging is involved. "As asset prices correct, wanton speculation is curtailed," Camp says. "The levered players sell whatever they can, creating opportunities for long-term investors. This requisite capital reallocation is necessary and healthy long term."

Key question: What's the terminal rate?

Just as important as the pace of rate hikes is the terminal rate, says Camp. The Fed is likely to meet substantial resistance around the 3.25% to 3.75% level on the fed funds rate. "Either inflation begins to moderate at these levels or credit conditions deteriorate beyond what the Fed deems acceptable," Camp says. "The latter would have ramifications across risk assets. The 'Fed put' is still in play, but we're likely a ways away from the strike price."

Expect more front-loaded hikes

Camp says he expects the Fed to continue its front-loaded approach, with the potential for a pause later this year or early next year. His team expects supersized hikes (i.e., in the 50- to 75-basis point range) over the next two or three Federal Open Market Committee meetings, possibly followed by a 25-basis point hike at the December meeting. "That very well may be all we get from the Fed," says Camp.

'Levels we haven't seen in years'

Weak economic data is likely to keep the yield on the 10-year Treasury note in the 3.0% to 3.5% corridor that it's occupied over the last few weeks, says Camp. Given the flat shape of the yield curve, Camp generally recommends allocating new dollars to short- and intermediate-term paper. "Intermediate-term bonds are once again investable," he says. "The Treasury curve is yielding north of 3.0% two years and further out. Many intermediate high-quality corporate bonds yield north of 4.0% to 4.5%. Many municipal bonds have tax-adjusted yields between 4.5% and 5.0%. These are levels we haven't seen in years. It's worth noting that in recent weeks high-quality bonds have started to attract significant interest on days when equities have sold off, something that just did not happen during the first four months of 2022."

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Definitions

Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

The Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The U.S. Bureau of Labor Statistics bases the index on prices of food, clothing, shelter, fuels, transportation, doctors' and dentists' services, drugs, and other goods and services that people buy for day-to-day living. Prices are collected each month in 75 urban areas across the country from about 6,000 households and 22,000 retailers.

A credit spread is the difference in yield between a U.S. Treasury bond and another debt security with the same maturity but different credit quality. Also referred to as "bond spreads" or "default spreads," credit spreads are measured in basis points, with a 1% difference in yield equaling a spread of 100 basis points. Credit spreads reflect the risk of the debt security being compared with the Treasury bond, which is considered to be risk-free. Higher quality securities have a lower chance of the issuer defaulting. Lower quality securities have a higher chance of the issuer defaulting.

The term "Fed put" is an adaption of the option term "put," and it describes the belief among market participants that the U.S. Federal Reserve would step in and implement policies to limit the equity market's decline beyond a certain point.

A strike price is a term used generally in reference to derivative contracts such as put options. Put options are financial contracts that give the buyer of the option the right, but not the obligation, to sell a specified amount of a stock, bond, commodity, or other instrument at a pre-determined price (the "strike price') within a specified time frame. Put options increase in value as the price of the underlying asset falls, as the volatility in the price of the underlying asset increases, or as interest rates decline.

The federal funds rate is the target interest rate set by the Federal Open Market Committee of the U.S. Federal reserve. The target is the Fed's suggested rate for commercial banks to borrow and lend their excess reserves to each other overnight.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

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