Fed delivers third consecutive outsized 0.75% interest rate hike in effort to cool inflation

Key takeaways

- The U.S. Federal Reserve increased interest rates by 0.75% for the third consecutive meeting in an ongoing attempt to cool inflation.
- The Fed's new Summary of Economic Projections indicates members' expectation for lower 2023 growth paired with higher unemployment, inflation and interest rates relative to their June projections.
- Bond markets imply investors expect the Fed's target interest rate will peak around 4.5% in the first half of next year from the current range of 3% to 3.25%.

The Federal Reserve (Fed) increased its target federal funds interest rate by 0.75% to a range of 3.00% to 3.25% today following the conclusion of its regularly scheduled two-day meeting, consistent with investor expectations and Fed board member comments in recent weeks. Inflation has fallen from a 40-year high above 9% to just above 8%. While inflation may have already reached its peak, persistent high prices remain the primary catalyst for aggressive Fed tightening.

The Fed typically changes policy rates in 0.25% increments; today's third consecutive 0.75% increase, preceded by 0.50% and 0.25% increases earlier this year, highlights the Fed's resolve to fight inflation. The Fed's updated Summary of Economic Projections (SEP) downgraded their economic outlook, reflecting lower 2023 growth expectations paired with higher expectations for interest rates, the unemployment rate and inflation. The SEP indicates the median Fed member plots their target funds rate at 4.38% for the end of this year and 4.62% for the end of 2023, somewhat higher than investors anticipated pre-announcement.

Investors' attention focused on Fed Chairman Jerome Powell's press conference and the updated SEP, since the 0.75% rate hike was generally in line with consensus economist expectations. The magnitude of the downgrade in the Fed's economic outlook generated the biggest investor reaction today, sending stocks lower and short-term bond yields higher. The new SEP lowered 2023 gross domestic product (GDP, a measure of total output from an economy) growth expectations to 1.2% (down from 1.7% in the June projection), while raising core inflation to 3.1% (up from 2.7%) and elevating the unemployment rate to 4.4% (up from 3.9% in June). Powell noted during the press conference, "(The) focus of the committee is getting inflation back down to 2%. To accomplish that, we'll need to do two things in particular: to achieve a period of growth below trend, and a softening in labor market conditions to foster a better balance." His comments remain consistent with previous Fed messaging insisting their sphere of influence to reduce inflation involves reducing demand for goods and services rather than increasing supply.

The Fed remains in the early stages of reducing its $8.5 trillion Treasury and mortgage bond holdings, which were originally accumulated to suppress interest rates in response to the global pandemic's outset. The Fed announced it would allow up to $47.5 billion per month of bonds to mature beginning in June followed by $95 billion per

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month beginning this month, forcing investors to absorb the incremental supply. In addition to restraining post-pandemic bond yields and encouraging borrowing, the Fed's bond buying also replaced bond holdings with money, which can support economic activity through added liquidity. Thus far, the Fed's balance sheet has shrunk by an inconsequential amount, but if its bond portfolio runoff continues, bond yields (which move in the opposite direction of bond prices) could be nudged higher, dampening liquidity and, in turn, reducing a portion of the fuel available for future economic growth.

Stock prices fell after the announcement, then rose briefly during the press conference before once again, declining into the close, with the S&P 500 finishing down 1.7%, reflecting the Fed's downgraded economic projections. Ten-year Treasury yields remained elevated above the 3.5% level, near the highest yield in over a decade. Likewise, the two-year Treasury yield above 4% remains near the highest level in 15 years. Higher bond yields and interest rates reflect higher financing costs, which can dampen economic activity.

Monetary policy, defined as central bank interest rate target decisions, continues tightening around the globe. This year's first and second quarters set consecutive records for the most net rate hikes (the number of central banks raising interest rates less those lowering rates) across the 60 central banks we have tracked, with that analysis dating to 2004. The third quarter remains on pace for another round of aggressive global rate hikes. Simultaneously, decelerating growth continues across most regions of the globe. Tighter monetary conditions paired with slowing growth are two key factors influencing our somewhat defensive positioning in diversified investment portfolios.

While corporate earnings have remained resilient to date, highlighting large companies' ability to alleviate or pass along higher prices, third quarter results and management guidance beginning this month will provide more insight into the magnitude of profit margin pressures and overall earnings. We continue monitoring consumer health as inflation hurts purchasing power and sentiment. In aggregate, consumers came into 2022 in a strong position, which masks pain within lower-income cohorts. We retain a more defensive portfolio bias, anticipating ongoing volatility in the near term and see opportunities in high-quality bonds and global infrastructure investments relative to stocks. Within bond allocations, retaining high-quality bond exposure represents a critical portfolio component to managing portfolio risk, particularly now that higher bond yields better reflect expectations for ongoing aggressive central bank rate hikes.

As always, we value your trust and are here to help in any way we can. Please do not hesitate to let us know if we can help address your unique financial situation or be of assistance.

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