Capital Markets Strategy
Essential inCights for the C-Suite

Chart of the Day

Exactly one year ago, Fed policy rates were at 0% and the Federal Reserve was still expanding its balance sheet via quantitative easing. Since then, the buzzwords "**transitory inflation**" which dominated market debate in 2022 have been replaced by a renewed assessment on whether Fed policy is "**sufficiently restrictive**" in 2023.

Since last March, the Fed has raised its policy rate on eight occasions, most recently to a range of 4.50-4.75%. Combined with a reduction in its balance sheet (QT) which began in June, this has been the most aggressive Fed tightening cycle in 40 years. **Whether or not policy is "sufficiently restrictive," however, will ultimately be determined by whether the combination of Fed policy and communication will put inflation back on a path to 2% - an ambiguous and arguably unknowable target in advance.**

Forty years ago, Fed Chair Paul Volcker raised policy rates 5% ABOVE inflation at the peak of the cycle. **Today, by comparison, Fed Funds are still negative in real terms (i.e., below the rate of inflation), and well below levels implied by the Taylor Rule framework, both of which suggest that Fed policy is not yet sufficiently restrictive**.

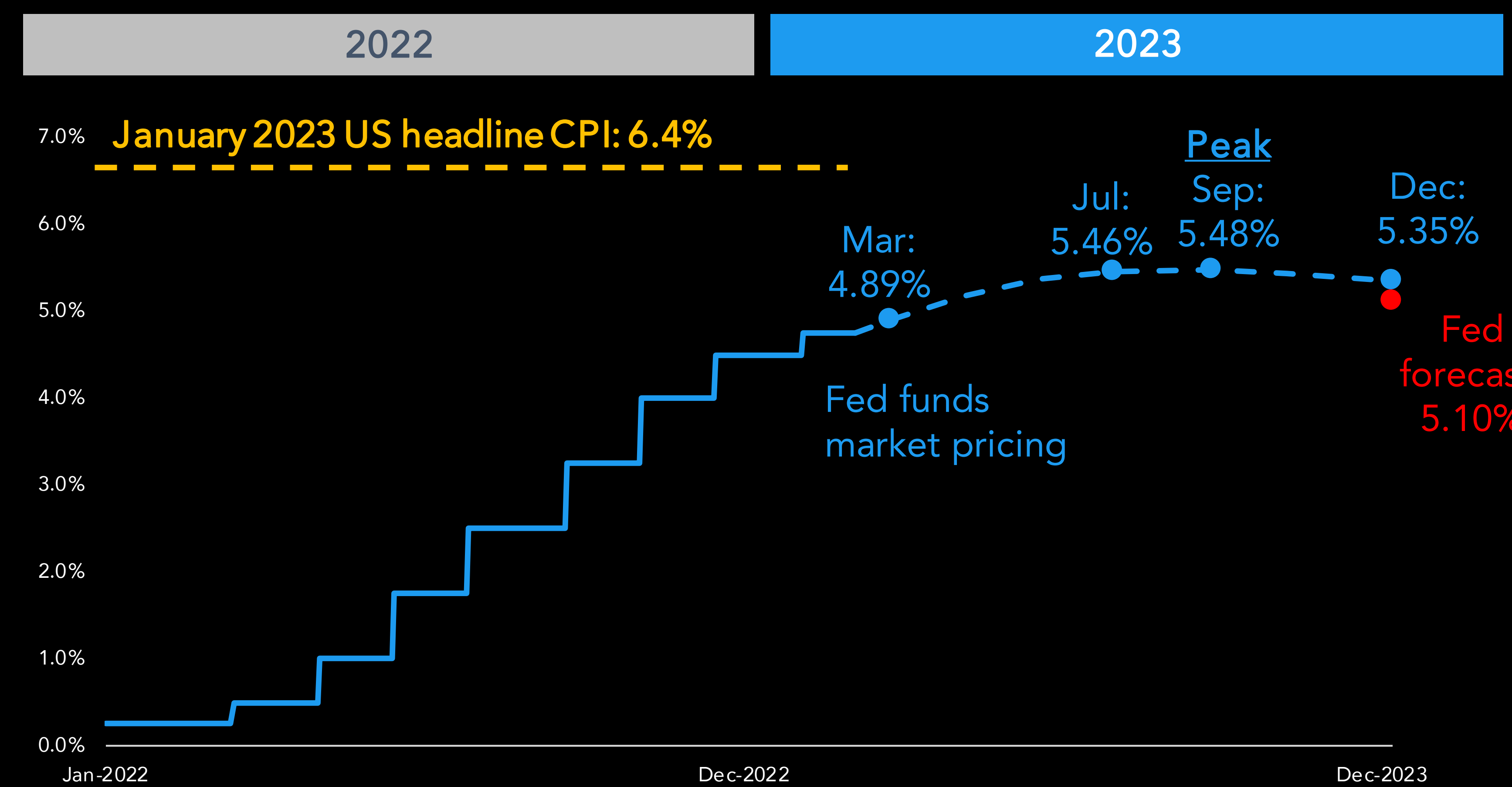
Both market pricing and Fed policy have repeatedly "fallen behind" inflation in the current cycle, and that is likely true today as well. With "sticky" services inflation likely to become more dominant than the "disinflation" narrative driving markets in recent months, the Fed's insufficiently restrictive policy stance is likely to precipitate significant volatility and repricing on risk assets in the months ahead (i.e., equities, HY credit spreads, EMFX).

Looking ahead, markets will be closely watching whether the Fed opts for a larger rate increase (50 bps) or maintains its recent slower pace (25 bps) at the next FOMC meeting on March 21-22. While the Fed is currently guiding policy toward a peak of 5.1%, more than 1/3 of Fed officials anticipate lifting the rate above 5.25%. **Markets are currently pricing in nearly 90 bps of additional Fed tightening in 2023, while option-adjusted probabilities are assigning more than a 20% chance of a 6% Fed Funds policy rate by year end**.

While market pricing and Fed guidance on rates may still not be tight enough, how high the Fed goes may ultimately be less important than what they do next (i.e., "higher for longer" or "pivot lower").

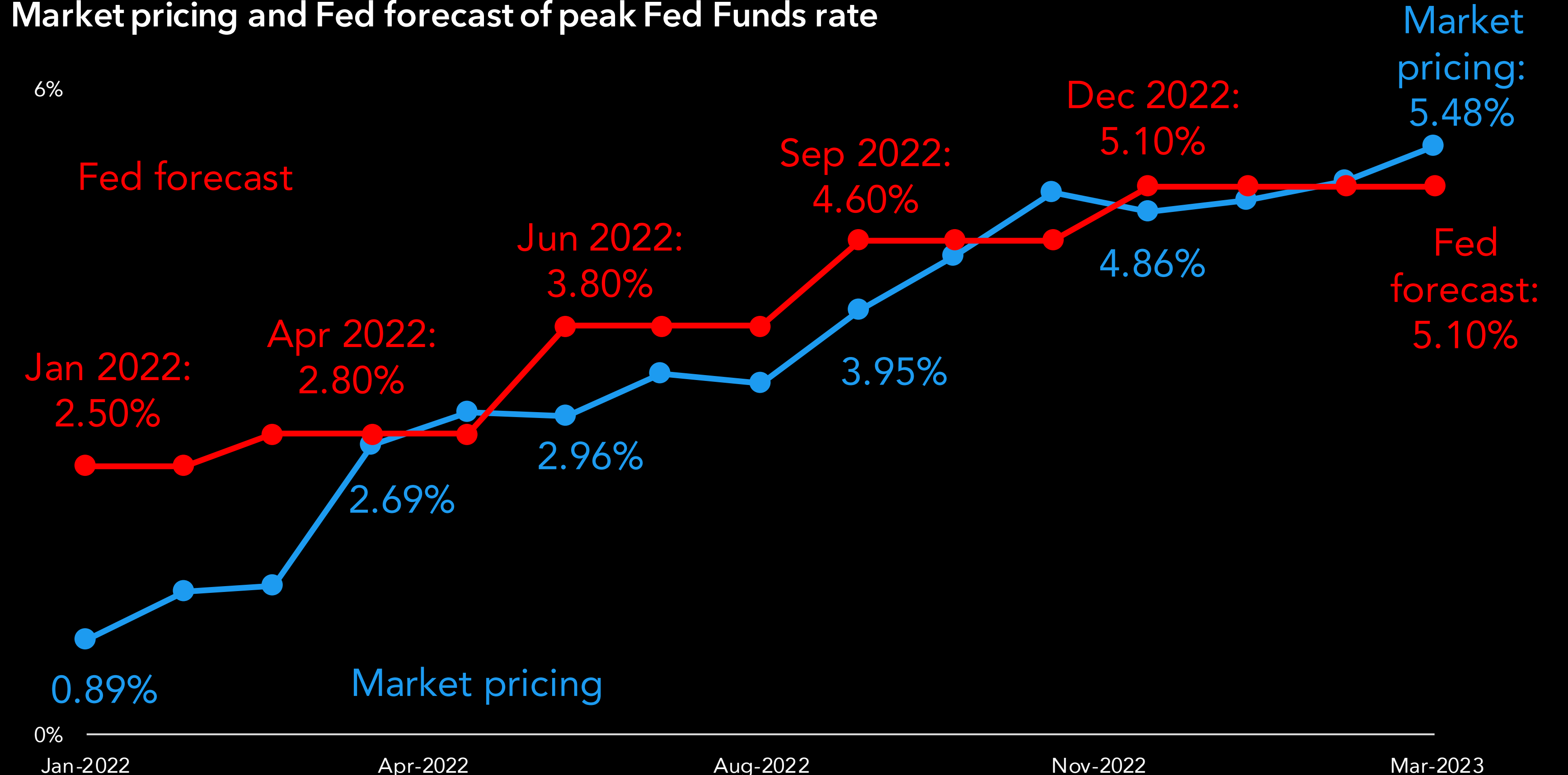
The Fed's benchmark policy rate is still negative in real terms (i.e., below the rate of inflation), and well below levels implied by the Taylor Rule framework, both of which suggest that Fed policy is not yet sufficiently restrictive.

Fed funds rate and market pricing



For much of the last year, the Fed has been "behind the curve" on inflation, while markets have been "behind the Fed" for most of this period. As recently as 6 months ago, markets were pricing in "peak Fed Funds" at only 3.5%. Today, markets are pricing in nearly 90 bps of additional Fed tightening in 2023, with peak Fed Funds at nearly 5.5%, while option-adjusted probabilities are assigning more than a 20% chance of a 6% Fed Funds policy rate by year end.

Market pricing and Fed forecast of peak Fed Funds rate



Source: (1-2) Bloomberg. Data as of March 2, 2023.

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"Macro stability isn't everything, but without it, you have nothing."