July 27, 2022

The Fed's Finally Getting in the Zone

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The Federal Reserve's latest 75 bps rate hike was accompanied by a more nuanced tone. While it emphasized continued vigilance in fighting inflation, it acknowledged the slowdown in certain economic segments. At this point in the tightening cycle, Powell suggested it is becoming appropriate to move to a more data-dependent approach - an acknowledgement that boosted risk assets. The desire to heal supply conditions indicates a tricky, but not unachievable, landing from here. Interest rates are now likely to enter a plateau phase as the market waits for the Fed to catch up with market pricing. From a longer-term perspective, if we are at a multi-decade high for nominal growth and inflation, the same may apply to rates as well.

The FOMC's statement indicated no let-up in the Fed's pursuit of lower inflation. Chairman Powell hammered that message home right out of the chute at the press conference by reiterating that the Fed is strongly committed to lowering inflation. While the Fed gave a nod to recent softening in spending and production data, it also noted ongoing robust job gains and low unemployment, suggesting they think they have more wood to chop and will follow through with additional rate hikes from here. But now that they hiked the funds rate into the range that most Fed officials think is neutral, Powell indicated that, from here, the Fed will be making decisions on a meeting-by-meeting basis.

Given the confluence of more mixed economic data and expectations that lower energy prices will at least help moderate headline inflation in July's CPI reading, we anticipate the Fed's pace of rate hikes will likely slow down a bit from here. The Fed's quantitative tightening will be ramping up to full speed in September, further adding to the tightening in financial conditions created by the Fed's rate hikes thus far. Moreover, the full effects of the Fed's tightening to date are likely still in the pipeline - an important consideration now that the Fed is on the cusp of entering into what it thinks is restrictive policy territory.

However, the current economic environment - with its major upheavals and shifting cross currents in demand and supply conditions - has created an unusually heightened degree of uncertainty as to where the economy is headed from here. Powell noted several times that the Fed's overall aim is to bring economic growth not just back down to potential, but to also temporarily lower it somewhat below potential in order to allow supply conditions time to catch up. But that suggests a narrow target zone for the Fed as there may be a fine point between tightening enough to curtail demand conditions, while not tightening so much as to choke off much-needed investment that would benefit supply conditions. That said, we agree that a soft landing is still possible. And the Fed's shift to becoming much more data dependent at this stage of its tightening cycle likely adds to that possibility.

Yields to Remain in a Range: Now that we're Somewhere, What's the Rush?

The Fed has gotten to their first objective: the neutral zone. While nothing suggests they are done, the evolving path of growth and inflation, as noted above and by the Chairman himself, suggests the pace of hikes is likely to slow. As a result, the Treasury market should now enter a plateau phase, similar to the last two cycles shown in Figure 1. With the market priced for a bit of additional hikes, it is likely time for the rates market to simply wait until either the Fed catches up or it becomes clear that a break higher or lower is warranted.

FIGURE 1: Bond Yields Likely to Enter a “Plateau” Phase While They Wait for the Fed to Finish Catching Up (%)

Source: PGIM Fixed Income and Bloomberg as of July 27, 2022.

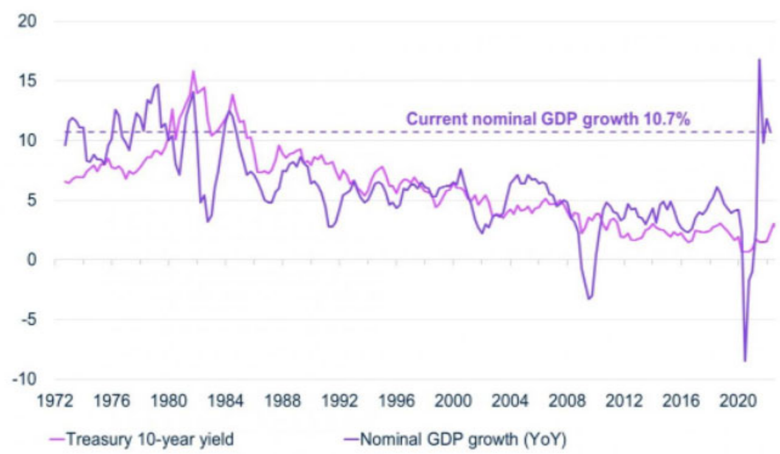
Some Questions, but also Answers, About the Long-term Outlook for Rates...

Looking beyond this year’s plateau, unlike so many cycles that have witnessed only brief peaks in the Fed funds rate, the current episode could resemble more of a 1994-2000 cycle with an extended high range for rates. Given the long tail of the COVID reopening expansion with its searing rate of inflation, this cycle could necessitate a more extended period of “high” interest rates (e.g., 3%) or even a stint towards 4% should growth and inflation remain elevated. Although seemingly less likely at this point, next year could see lower rates if growth drops off rapidly, pulling forward the prospects for a drop in inflation. In other words, the range of potential outcomes for rates next year—despite the elevated starting point - is uncharacteristically wide open.

But Big Picture, When Looking Back, We'll See that Current Rates are Actually High

Although next year’s prospects look quite uncertain, from a longer-term perspective the picture seems to come back into focus. If growth and inflation are the key determinants of interest rates, then stop and consider that the current rate of nominal GDP growth (the sum of growth and inflation) has not been this high since the early 1980s and may very well not be this high again for years or even decades to come (Figure 2).

FIGURE 2: Nominal GDP growth (real GDP growth + inflation) is at multi-generational highs, and this has pushed up interest rates to the highest levels since the GFC. While the outlook in the coming quarters is less clear, looking several years out to a point where the COVID boost to growth and inflation has passed, it seems inevitable that both growth and inflation will drop back to pre-COVID levels, which in turn is likely to pull rates down from current levels. (%)



Source: PGIM Fixed Income and Bloomberg as of July 27, 2022.

If we are at a multi-decade high in growth and inflation, then we are probably at what will turn out to be a multi-decade high in interest rates as well. So, once the COVID reopening demand is gone, the supply chain issues are resolved, and underlying secular trends pull the economy back towards the pre-COVID configuration of moderate growth and inflation, several things seem highly likely:

1. there will be a reprise back to lower interest rates;
2. from that vantage point looking back, current rates will look high in retrospect; and
3. the peak in rates for this cycle (whether already behind us or yet ahead in the coming quarters) seems destined to set a high-water mark for some time to come.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of July 27, 2022.

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2022-4859

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