Caron's Corner Transcript – 7.26.2023

Fed Recap: We Are All Now Data Dependent – Choppy Markets Ahead

- The Fed hiked 25 basis points as expected
- They reiterated that they are data dependent, which leaves the door open for another 25 basis point hike at the September or November meeting.
- We too are data dependent - and expect choppy markets between now and September.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. Well, we can put this Fed meeting behind us for now. I think many were hoping or thinking that this would be the last Fed rate hike in the cycle, but I think the Fed may be disappointing us on that score. The key quote from the press conference is that the Fed remains "patient but resolute toward fighting inflation." What this really means is that the door is wide open for more rate hikes, whether in September or November or maybe even at all. But the door is open and it will really depend on the incoming data. There was nothing in Powell's comments that led me to believe that the July hike was the last one in the cycle. This was not communicated at all, and it's a double-edged sword for asset prices. It could be riskier for the bond market, but provide underlying support for equities. This is because inflation may stay elevated, but descend slowly, and that's really the key. This is actually good for earnings, which supports equities, but it does put pressure on the lower-yielding, line-dated bond sector. So let's get into the press conference and discuss some of my key takeaways.

First, as we all know, the Fed hiked 25 basis points as expected and they reiterated that they are "data dependent," leaving the door open for another 25 basis point hike in September or November. What data are they going to be depending on? Well later this week, we have the ECI (Employment Cost Index) report. After that we have two more CPI (Consumer Price Index) reports before the next Fed meeting on September 20th. We also have two more labor reports before the September 20th meeting. If we note that headline inflation has fallen to 3%, which is definitely comfortable - and Powell did comment on that - he also stated that there is a "distance between core inflation and their 2% goal." Note that the last core CPI print was 4.8%. Now, remember the Fed focuses on **core** inflation (i.e. core PCE (Personal Consumption Expenditures) inflation). So, while headline inflation has come down, core inflation has remained sticky high. Now the base effects are likely to push core inflation lower, but it still remains too high for comfort. The base effects are likely to be friendly toward lowering that core CPI, but will it fall soon enough and by far enough and then actually remain anchored? That is key and the whole point of this. Powell stated that the Fed needs to believe that inflation is "durably down" and that's another way of saying "anchored," a word that I like to use. But then he goes back to stress that core measures of inflation are too high. He's acknowledging this very plainly.

Another quote that I thought was interesting from Powell was that "the worst outcome is to **not** get inflation down today because whatever the social costs are near term, it's much worse later if inflation stays high." Historically, that is true and it seems Powell is very focused on this. But I think it's also interesting that he continued to caveat that aspect of the necessity to get inflation down by again

focusing on core. So the reiteration of this comment, which Powell has said many times before, does not make it seem like 1) the Fed is done hiking and 2) the Fed will cut rates anytime soon despite what the market is pricing.

Other key supporting quotes that I found interesting were that “We, the Fed, need to be prepared to raise further” and that the terminal policy rate will have to be “restrictive” for some time. To repeat, this is really pushing back against the rate cuts that are being priced into the markets today. On the flip side, Powell also said that the **real** Fed funds rate - the nominal Fed funds rate minus inflation - is actually higher and in restrictive territory. This means they are making progress toward tightening policy to bring down inflation. But clearly it may not be enough.

So look, the key comment I took away from the Fed's press conference was when Powell said that given all of the previous rate hikes that the Fed can remain patient, but resolute, on fighting inflation. This does not signal that July is the last hike in the cycle. Putting it all together from a market's perspective, based on market pricing for July to mark the end of the rate hiking cycle, to be followed by rate cuts in the first half of 2024, I think the risk is that inflation does not fall as quickly as needed to sideline the Fed. This puts bond market pricing, especially in the longer duration assets, given the inverted levels of the curve, at some risk. However, since higher than ordinary inflation has been supportive for earnings and equity prices, it may be that the slow descent of inflation may remain supportive for equity assets longer.

So here we are with a Fed leaving the door wide open for more rate hikes, but they're going to be very data dependent. It also tells us that this could add to volatility because if we start to see these data prints come up, we're going to be very focused on them and you know, these data prints can be noisy. Sometimes they might go up a little bit before going down a little bit, and I think the market's going to make a big deal about that. In fact, I think the markets are going to be very, very choppy between now and the next Fed meeting on September 20th as we **all** focus on the data. So it's not just the Fed that's data dependent, but it's all of us now.

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