Caron’s Corner Transcript – 11.1.2023

FOMC Recap: Is the Fed Focusing on Asset Prices Through Financial Conditions?

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. We may have learned something new at today's Fed meeting, that their policy reaction function may focus on asset prices through their financial conditions metric. What this really is asking is whether the Fed is focusing on asset prices through this financial conditions metric. It's no surprise that the Fed left rates unchanged and that they upgraded economic conditions. Fed Chair Powell said, and I quote, “There has been a strong pace of growth which has been above expectations.” But he also simultaneously said “that financial conditions have recently tightened.” What does that really mean? What does “financial conditions” mean? Look, he talked about this quite a bit. Remember that “financial conditions” is an index when the Fed is talking about it, specifically an index of short-term interest rates, intermediate-term interest rates, credit spreads, equities and the US dollar. A tightening of financial conditions effectively means higher interest rates, wider credit spreads and lower equity prices. It means that financial conditions have become tighter, that they've effectively deteriorated and that's essentially what's happened.

Powell is somewhat happy about that, but inflation is still not coming down to the levels that he needs them to be. The implication is the Fed is acknowledging that bond yields have risen and that mortgage rates are higher and that the cost of capital is rising for business. That essentially is a tightening of financial conditions and should be good news for the Fed. But the jobs market remains strong, and inflation remains well above its long-run goals and core PCE is 3.7% versus the target of 2%. The goal is to move inflation sustainably - or anchored - to the Fed's target of around 2%. And there's a lot more work to be done before there is confidence that this will be achieved. That's a quote from Powell. Notably, the hawks on the Fed will believe that the longer we're above 2% inflation, the longer and harder it will be to actually achieve that 2% target. The question here is not if inflation is falling or will fall - it certainly is falling - but whether the recent rise in bond yields and subsequent tightening of financial conditions is enough to justify or to just keep inflation lower – and not just lower it but also keep it anchored lower. Nowhere in the Fed statement or press conference does it suggest we have achieved the Fed's goal. That's a confidence in keeping inflation down, and this then is why the Fed maintains a hawkish bias.

Let's go back to Powell. He talks about financial conditions in his press conference and that financial conditions need to be consistently tight in material and not fluctuating - and it's too soon to tell if this is the case. Powell is not yet confident that financial conditions are tight enough to reach their 2% inflation target. In my mind this keeps the door wide open for the possibility of a December rate hike. Market probability currently only has a December rate hike at 23% - and this is too low in my opinion. This does not imply that the Fed will hike interest rates in December, but bond yields and a further tightening of financial conditions is required for the Fed to remain patient and hold steady. The bar is a little bit higher now for the Fed to stay “on hold.”

Financial conditions were the focal point of today's meeting and that's why I have repeated that term over and over again. It seems that the Fed would prefer not to hike rates, but they need to see a further tightening of financial conditions to do the work for them. What that also means is that if equities rally and credit spreads narrow - in other words, we get a risk-on event in the market - then the Fed may do some saber rattling to signal to the market that they could still hike one more time. This is informative because it seems that the policy reaction function from the Fed is shifting toward a weakening in financial asset prices as a leading indicator for a potential decline in inflation. This is the key takeaway for me. That said, Powell also stated that we may need to see weaker economic conditions, slower growth rates and a softening of the labor market as requirements for inflation to fall to acceptable levels and become anchored there.

So what's the conclusion? What's the big takeaway here? The big change in today's statement seems to be the focus on financial conditions. The Fed had long attached the need for the labor market to soften to bring down inflation and keep it lower sustainably, essentially the Phillips curve effect. But labor markets have remained strong, so it seems the Fed is now on to something else, which is that higher rates should soften asset prices, which means having tighter financial conditions. So a softening of asset prices might be the key for the Fed and that should feed back to a slower economy and ultimately lower inflation. That's the linkage the Fed is starting to make, and this is a divergence that I think is important to focus on. Now, I wouldn't say the Fed's policy reaction function is squarely focused on slowing asset prices as a means to lower inflation. But it does seem like it's starting to represent a greater weight in their calculus. Maybe they are realizing that exogenous factors have kept the labor market tighter than usual, and that they now need to focus on to something else to slow inflation. That is a tightening of the financial market, or said another way, a lowering of financial market asset prices.

As for the market's reaction post Fed, well, financial conditions actually eased. They didn't tighten. Bond yields fell sharply and equities rose sharply. Now we'll see over the coming days if this sustains itself. But so far that's the market’s initial reaction, and this creates a risk that the Fed might try to restore a hawkish bias that tightens financial conditions. Stay tuned.

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