VIEWPOINTS

Markets Are Finally Listening to Fed's 'Ongoing Increases' Message

Bond markets are pricing in additional Federal Reserve interest rate hikes, acknowledging the central bank's emphatic resolve to tame inflation despite the likely trade-offs.

BY **RICHARD CLARIDA** | FEBRUARY 22, 2023

It's been a busy month for investors and Fed watchers. On 1 February, after announcing a 25 basis point hike in the federal funds rate, the U.S. Federal Reserve went on to state that it anticipates that "ongoing increases" would be appropriate in order to move monetary policy into the restrictive range needed to put U.S. inflation on a path to return over time to the Fed's 2% longer-run goal.

Two days later, a blockbuster U.S. employment report for January triggered an immediate repricing in bond markets toward a higher peak level for the fed funds rate. In the following week, a parade of Fed speakers led by Chair Jerome Powell consistently reinforced the "ongoing increases" message. Then last week, higher-than-expected data on U.S. Consumer Price Index (CPI) inflation and stronger-than-expected data on retail sales as well as additional remarks from Fed officials together triggered markets to price in not only the two additional rate hikes indicated by the Fed's December 2022 dot plot (part of its Summary of Economic Projections), but also a material likelihood of at least one additional hike after that, which would bring the top of the range for the federal funds rate to 5.5%.

These developments illustrate well the interplay among data, destination, and market dynamics we are likely to experience in the year ahead as the Fed tries to engineer what we would characterize as a "softish" (if not soft) landing for the U.S. economy by ratcheting down aggregate demand growth into better balance with aggregate supply in its pursuit of its longer-run price stability mandate. Fed officials have asserted that the risk of doing too little to reduce inflation exceeds the risk of doing too much. But our view remains that they've already done most of the heavy lifting they will need to do before they pause rate hikes later this year, although as explained in a recent blog post by my colleagues Tiffany Wilding and Allison Boxer following the release of January CPI data, the risk is to the upside on the peak fed funds rate we will see in this cycle if progress on reducing inflation is slower than the Fed expects.

Understanding the Fed's concerted efforts to tame inflation helps explain much of what we're seeing in markets and the broader U.S. economy, and informs what to watch and what to expect over the coming year.

Markets repricing to projected peak rates and forward guidance

The fed funds rate last rose to 4.75% (on its way to 5.25%!) in 2006. While that's not exactly ancient history, it's long enough ago that markets are taking some time to adjust to a yield curve anchored at such a level. And one would have to look further back – decades – to find the last time the Fed undertook such a rapid pace of monetary tightening as it did in 2022. A crucial difference today as compared with previous major rate hike cycles is communication: The Fed has become much more transparent, offering detailed projections, targets, and guidance along with speeches, commentaries, testimony, and research.

But investors should remain attentive to the occasional episodic disconnects observed between Fed guidance and some prominent indices of financial conditions, as I discussed in a previous *Viewpoint* in December. While financial conditions according to some indexes have eased somewhat, recall that monetary policy operates with lags, meaning the U.S. economy likely has not yet absorbed the full force of Fed tightening to date. As Chair Powell indicated in his 1 February press conference, some of this apparent disconnect reflects investors' collective belief (demonstrated by market pricing) that inflation levels will fall faster this year than the Fed projects.

The trade-off between inflation and unemployment amid potential recession

Amid the challenge of taming inflation, the Fed also remains focused on assessing and supporting the level of maximum employment in the post-pandemic economy consistent with its 2% inflation objective. The U.S. labor market has undergone a significant transformation since the pandemic: Labor force participation has plunged, companies struggle to fill open positions, and wage gains have been running well ahead of a pace consistent with underlying productivity and the Fed's inflation target.

Fed Chair Powell stated on 1 February that "the labor market continues to be out of balance." While recent data suggest wage inflation is starting to slow, some rise in U.S. unemployment is still likely to be required to return inflation over time to the 2% target. For example, the Fed's own forecasts project that the unemployment rate could rise by 1.2 percentage points this year.

Historically, rises in the unemployment rate of this magnitude have occurred only in recessions. At PIMCO, our base case includes a recession, but all recessions are not created equal. We see no reason to believe that the growth slowdown the Fed is engineering need result in a deep and prolonged recession. For example, in the relatively brief U.S. recessions in 1990 and 2001, GDP growth in those calendar years was actually modestly positive, and the rise in the unemployment rate was roughly in line with what the Fed is projecting for 2023. If one year from now, we look back and see that GDP growth in 2023 was positive and that the unemployment rate ended the year somewhere between 4%–5%, that would likely qualify as a softish landing for the U.S. economy, even though it likely would be designated an official recession by the National Bureau of Economic Research (NBER).

Investment implications

With rate hikes largely behind us and the Fed committed to returning inflation to target over time, the investment philosophies that served many investors well prior to 2022 have become relevant again. Think of the basic concepts: diversification, active management, risk mitigation. In particular, fixed income markets are poised for attractive returns, given starting yields are at levels not seen in years. As we phrased it in PIMCO's latest *Cyclical Outlook*, "Bonds are back." We see opportunities in core fixed income, mortgage-backed securities, high quality credit, commodities, and inflation-linked bonds.

DISCLOSURES