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The Bottom Line

DECEMBER 2022

Relevant Insights for the Savvy Investor

A Slowdown in the Pace of Raising Rates, Not a Pivot

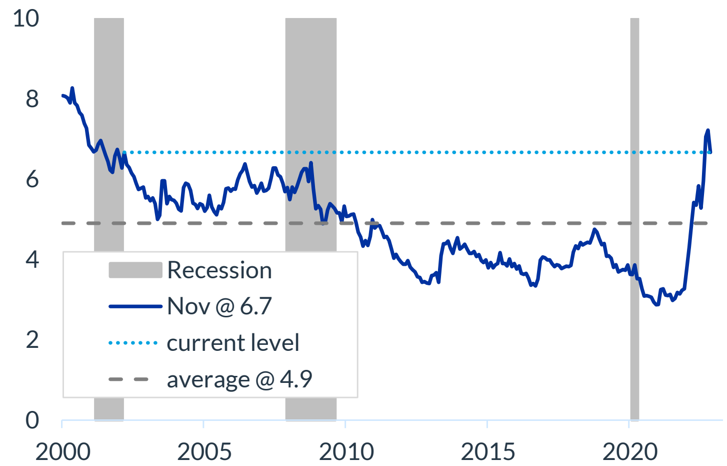
In regards to monetary policy, the Federal Reserve Bank appears to be in a transition phase.

This week, at its final meeting of the year, the Fed raised the federal funds rate by 50 basis points. This is a step down from its unprecedented series of 75 basis point hikes at each of the past four meetings. A slowdown in the pace of rate increases is needed because the Fed wants more time to see how past increases have impacted the economy.

This is not the much ballyhooed "pivot" by the Fed. The Fed is not turning dovish and has no plans to soon ease monetary policy. In fact, Fed Chair Powell has spoken in the past few weeks and has reiterated that the Fed has a long way to go to bring inflation under control. Instead, the Fed is just merely slowing down the pace of Fed tightening. Economists often use automotive analogies to describe Fed actions. In this case, the Fed is just slowing the speed of the car from 75 mph to 50 mph, but it is still proceeding forward. Furthermore, the Fed has increased its previous forecasted peak in the federal funds rate (4.6%) to a higher level (5.1%). This means the exit ramp for the Fed will be pushed further down the highway.

The slower pace of raising interest rates buys the Fed time. They want more time to see how the economy has responded to the hikes so far. It takes time for the full effects of those rate increases to ripple through the economy. Some parts of the economy that are sensitive to interest rates, like home sales, are responding to the highest level of mortgage rates in around 20 years (chart 1) and sales are slowing (chart 2). Others, like vehicle sales, continue to increase

CHART 1: Mortgage Rates (%)
30-year Fixed Rate Mortgage

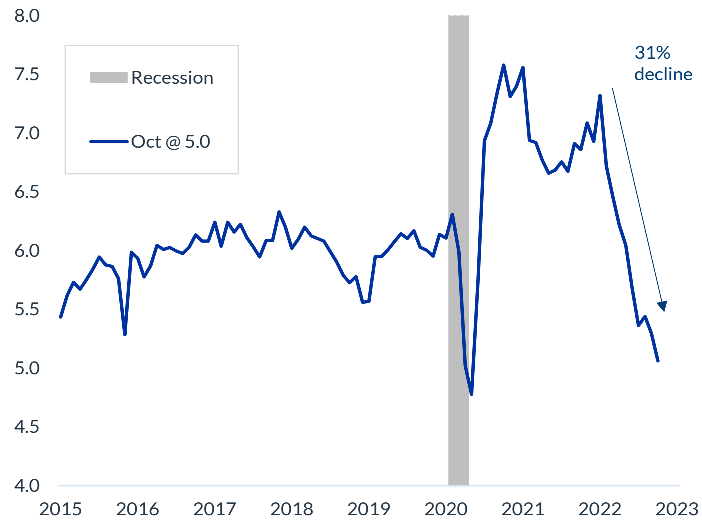


Source: Bankrate.com, November 2022.

(chart 3) despite the highest financing costs in about a decade (chart 4). This is due to pent-up demand from the lack of new vehicles for sale in the past few years due to supply chain issues in manufacturing, most notably the shortage of semi-conductor chips. Even with the recent increase in sales, they are well below the average level from before the pandemic (chart 3).

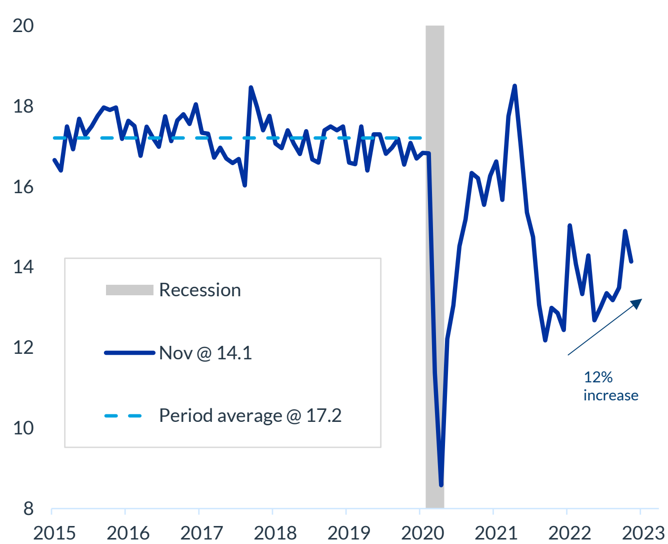
The Fed's goal is a soft landing for the economy. They want to raise interest rates just enough to soften the job market, which would lead to slower wage growth, helping to lower inflation, which should allow the positive growth of the economy to continue. But that is not an easy task. The Fed does not want to overtighten. Because that would mean they would have to cut interest rates soon. Instead, the Fed needs the time to figure out and adjust interest rates to find the "Goldilocks" level to help ensure a continuation of economic growth without a recession.

CHART 2: New & Existing Home Sales
units, millions, seasonally adjusted annual rate



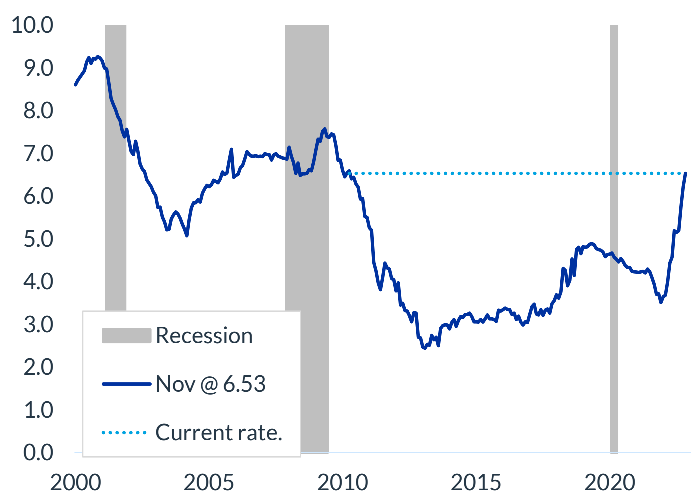
Source: National Association of Realtors, US Census Bureau, October 2022.

CHART 3: Vehicle Sales
million, seasonally adjusted annual rate



Source: Ward's Automotive Group, October 2022.

CHART 4: Auto Loans (%)



Source: Bankrate.com, November 2022.

Market Trends

Fueled by signs of moderating inflation and growing expectations for an easing in the pace of Fed tightening, the latest equity market rally has gained steam with the S&P 500 recording its first back-to-back monthly gains in over a year. While we agree that recent developments are encouraging, it's important to remember that rallies are common features of bear markets, and history suggests the path to a Fed pivot could be volatile for stocks due to elevated inflation and interest rate risk.

LABOR

Demand for workers is slowing, but wage pressures remain around 5.0% y-o-y, about 2 percentage points above what the Fed wants.[1]

THE FED

The Fed has reduced the size of increases in the funds rate, but at the same time, it has set a higher terminal rate 5.1%.[2]

HOUSING

Following the significant weakness in the home sales market, mortgage rates have fallen more than 50 bps after peaking at 7.35% in early November.[3]

TRADE DEFICIT

After reaching a record peak in March, the deficit started to decline, but the strong dollar has derailed that trend in the past two months due to higher export prices.[4]

INFLATION

For the second month in a row, inflationary pressures have declined significantly, and a long disinflationary trend appears to be underway.[5]

ENERGY

Energy prices continue to decline as fears of the global recession continue to grow, primarily based on China's ongoing problems with COVID-19.[6]

Sources

1. Bureau of Labor Statistics
2. The Federal Reserve
3. Bankrate.com, Commerce Department
4. Department of Commerce
5. Bureau of Labor Statistics
6. Energy Information Administration, Wall Street Journal

Index Definitions

CPI: The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

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