DO NOT DOUBT THE FED'S RESOLVE
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EAGLE | Asset Management

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INFLATION has turned central bank policy away from market accommodation

The U.S. Federal Reserve capped the sixth Federal Open Market Committee (FOMC) meeting of 2022 with its third consecutive 75-basis point interest rate hike. While capital markets had priced in an increase of this magnitude, they were spooked by the Fed's updated summary of economic projections (SEP) and forecast for the terminal federal funds rate. The Fed reduced its forecast for growth in real gross domestic product (GDP) of 0.2% in 2022, down from the 1.7% projection in June. The Fed's projection for the terminal fed funds rate increased from 4.4% to 4.6%.

This should be no surprise, says James Camp, CFA, Eagle Asset Management's Managing Director of Fixed Income and Strategic Income, since the Fed must slow demand to prevent inflation from becoming too entrenched in the economy.

Expect continued volatility

"Jobs 1, 2, and 3 for the Fed are inflation," Camp says. "We were not buyers of the Fed 'pivot' interpretation after July's FOMC meeting. With Inflation near multi-decade highs and the labor market showing very little weakness, the Fed has cover to continue with supersized hikes. After yesterday's press conference, there should be little doubt in the Fed's resolve to squash inflation."

The committee has now acknowledged that unemployment will likely rise from 3.7% to 4.4% as the Fed battles inflation. A move of this magnitude has always resulted in a recession. "This is a departure from central bank behavior in the post-Global Financial Crisis era," Camp says. "The Fed and other global central banks are no longer the provider of accommodation and liquidity at the first sign of stress. We expect volatility to continue as the market realizes this change in central bank behavior."

Camp's team sees the yield curve continuing to flatten and invert, a phenomenon caused by short-term rates moving higher than long-term rates. "With growth concerns continuing to mount, we believe we're in a peaking process for yields on long-term bonds like the 10-year. Short-term rates will continue to move higher as the Fed continues to hike. The Fed needs the fed funds rate to have a positive real yield in order to be sufficiently restrictive. That means we're roughly halfway through this tightening cycle. Considering the Fed's tools are blunt and function with a lag, we see an economic slowdown materializing in early 2023."

The most generous yields in a decade

With the sharp jump in yields across the curve, Camp says his team is finding value in bonds.

"We've been tactically underweight bonds in our multi-asset programs for the better part of the last 18 months," he says. "Yields today for both taxable and tax-exempt debt are more generous than any other point in the last decade. The yield on the 2-year U.S. Treasury is at its highest in 15 years. The weak macroeconomic backdrop also provides the potential for price returns in addition to coupons. For these reasons, we have been shifting our multi-asset portfolios in favor of bonds in recent months. For investors who are underweight fixed income, we're finding value at these levels."

Watch wage growth

Given the central bank's concerns about inflation becoming too entrenched, Camp expects similar-sized moves from the Fed to round out the year, with the most likely path for November and December bringing rate increases of 75 basis points and 50 basis points, respectively.

The key variable to monitor moving forward is wage inflation, says Camp. "Wage growth drives demand and bleeds into stickier forms of inflation such as housing," he says. "Wage growth will be a critical driver of Fed policy moving forward."

About Eagle Asset Management

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Definitions

Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

The federal funds rate is the target interest rate set by the Federal Open Market Committee of the U.S. Federal Reserve. The target is the Fed's suggested rate for commercial banks to borrow and lend their excess reserves to each other overnight.

Real gross domestic product (GDP) is nominal GDP adjusted for inflation. Nominal GDP is the total value of all goods and services produced in a specified time period, typically quarterly or yearly.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. Investors and market analysts watch certain yield curves for signs of inversion, when yields for longer-term debt instruments fall below yields on short-term debt with the same credit quality. Inversions are watched as potential signs of a weakening economy and in certain cases, a harbinger of recessions.

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