Week in Review

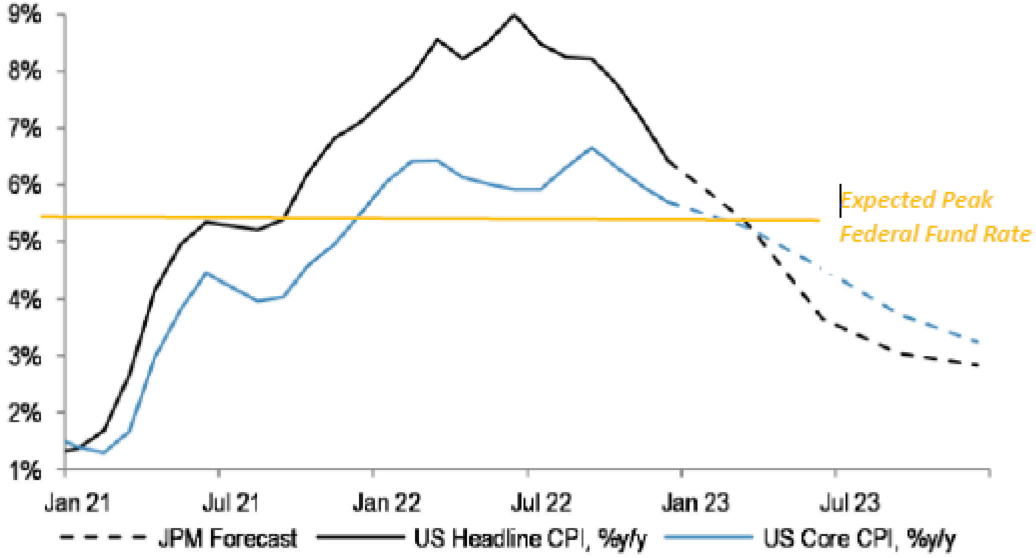
Friday, February 24, 2023

Inflation and Peak federal funds reflect a crossroad

While recent data indicates that inflation is still prominent, the trend has been down since peaking last summer. Meanwhile economic data has remained better than feared with unemployment at 3.4%, which is the lowest since 1969. The firmer economic growth has led to an increase in market implied expectation for the peak Federal Funds rate to 5.25%-5.5%.

Financial Markets Appear Set Up for Peak Federal Funds Rate Exceeding Inflation

U.S. Inflation Projections & Peak Fed Funds Rate



Source: J.P. Morgan Research and Bloomberg Finance

For financial markets, the impact has been rising short term yields with the 2-year treasury hitting the highest level since 2007 reaching 4.73% this past week supporting attractive yields for short term cash accounts. On the negative side, higher yields have weighed on longer term bond prices, capping a rally that started last October, and increased volatility and downward pressure on equities. Other market changes catalyzed by higher peak Fed Funds rate expectations have been a strengthening U.S. dollar, weaker relative performance by international markets, and a pullback in commodities such as gold.

While the relative strength in economic data has given cover for the Federal Reserve to remain hawkish in their commentary about keeping rates higher for longer, the possibility has been put in place that the Federal Funds rate might exceed the rate of inflation. There have been periods in the past when the Federal Funds rate has been higher than the rate of inflation, particularly during periods of tight monetary policy. For example, in the early 1980s, the Federal Reserve raised the Federal Funds rate to as high as 20% in response to high inflation rates, which were over 10% at the time.

A high relative Federal Funds rate to inflation has been effective in bringing down inflation in the past, however, the Federal Funds rate is a blunt instrument and had negative effects on economic growth and employment. For this reason, the market expects that the Federal Funds rate will ultimately follow the course of inflation lower assuming the Federal Reserve is confident that inflation will not flare up again and a hard economic landing can be averted.

Lower inflation and a pullback from the expected peak Federal Funds rate remain a work in progress as 2023 progresses but an important catalyst for positively impacting longer term equity and fixed income investments.