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## 9/30/22 Focal Point: Will the Markets Call the Fed's Raise and Hold Bluff?

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Our 6/30/22 Focal Point: Hard or Soft Landing discusses the first debate, which is still ongoing, on the depth of the economic slowdown. While this is ongoing, the question is now moving to how long the Fed will keep tightening policy in the face of a slowing economy.

The Fed's new catch phrase is now "raise and hold". It was introduced at its annual conference in Jackson Hole during August 2022. For a large portion of 2022, markets have been pricing the Fed to reach a rate peak in early 2023, but have then been pricing rate cuts to start by the end of 2023, reflected by bonds due in late 2023 yielding less than the Fed's target rate in March of 2023. The Fed did not like this, so adopted the "raise and hold" wording to keep interest rates near its terminal rate throughout 2023.

Here's the catch: "Raise and Hold" is about projecting where Fed policy will be a year from now. The Fed often introduces new concepts at Jackson Hole. A year ago, in August 2021 (Jackson Hole '21), we were getting a Fed mantra of "transitory" inflation. The Fed was thinking about tapering QE but was going slow, because the Delta and Omicron variants were still weighing on activity, and concern an early start to rate hikes could limit the ongoing economic recovery. A year before that, in August 2020, Powell's Jackson Hole speech introduced a new policy framework of not hiking rates until there were actual signs of inflation. In both 2020 and 2021, it was trying to support the economy and did not want the markets pricing rate hikes too soon, and so was trying to keep rates from rising too soon.

The 2020 and 2021 policy stances were seen as suggesting a certain Fed policy path, but it later deviated. This doesn't mean the Fed is bad at making forecasts. Nor does it mean it's bad for the Fed to shift its policy as the economy changes. But what it does mean is that the Fed is no better or worse at forecasting the economy and policy than anyone else. And often their "projected policy" is more about controlling the market and economy in the moment the forecast is given, not predicting where things will be.

Markets know monetary policy acts with a lag, and CPI and unemployment are lagging, not leading, indicators. They also see the rapid rate hikes, the rapid rise in rates in general (US and globally) and are wary of the impact that today's actions will have on the economy in 6 months. For the Fed to truly pivot in the face of a slowing economy and/or market stress, it needs to start seeing some progress on the CPI data. It's not ideal, but they have painted themselves into this corner.

Until the Fed pivots and shows signs of adjusting, “going too far” is a risk. This could mean a recession, a foreign exchange crisis, or other issue, such as the UK’s unfolding budget issue.

Will market uncertainty and volatility ultimately cause a risk to financial stability, and cause the Fed to act? Will the Fed really raise and hold, or are markets right that by mid-2023, actions already taken will have slowed inflation and the economy enough to allow the Fed to lower rates? *Will the Markets Call the Fed’s Raise and Hold Bluff?* The markets will be focused on this as 2022 comes to a close. Once the Fed shows a sign of a policy pivot, the markets themselves can pivot to gauging the depth of the downturn and starting to look past it. Until that point, concern over the timing and depth of the slowdown will keep a lid on the market.

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-The Standard & Poor’s 500 is a market capitalization weighted index of 500 widely held domestic stocks often used as a proxy for the U.S. stock market. The Standard & Poor’s 400 is a market capitalization weighted index of 400 mid cap domestic stocks. The Standard & Poor’s 600 is a market capitalization weighted index of 600 small cap domestic stocks.

-The NASDAQ Composite Index measures the performance of all issues listed in the NASDAQ stock market, except for rights, warrants, units, and convertible debentures.

-The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging markets. The MSCI All Country World Index is a free float adjusted market capitalization index designed to measure the performance of large and mid and cap stocks in 23 developed markets and 24 emerging markets. With over 2,800 constituents it represents over 85% of the global equity market.

-The Barclays Aggregate Index represents the total return performance (price change and income) of the US bond market, including Government, Agency, Mortgage and Corporate debt.

-The BofA Merrill Lynch Investment Grade and High Yield Indices are compiled by Bank of America / Merrill Lynch from the TRACE bond pricing service and intended to represent the total return performance (price change and income) of investment grade and high yield bonds.

-The S&P/LSTA U.S. Leveraged Loan 100 is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

-The S&P Municipal Bond Index is a broad, comprehensive, market value-weighted index. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing, in order to ensure that the Index remains current, while avoiding excessive turnover. The Index is rules based, although the Index Committee reserves the right to exercise discretion, when necessary.

-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

-The HFRI Fund of Funds index is compiled by the Hedge Funds Research Institute and is intended to represent the total return performance of the entire hedge fund universe.

