GENERALI INVESTMENTS

MARKET COMMENTARY

The Fed aims at shock therapy against inflation

Author: Paolo Zanghieri

June, 15 2022

- **The Fed radically stepped up its action plan to tame inflation. Not only it raised the Fed funds rate by 75bps but also signalled the intention to push it to 3.4% (90bps above neutral) by the end of the year. Rates should then peak at 3.8% next year before sliding back to 3.4% in 2024.**
- **The economic projections reflected the tighter policy stance, with a sizeable worsening in the growth outlook and an increase in unemployment. This – the FOMC expects – will allow for a drastic reduction in inflation next year.**
- **Fighting inflation is a priority and the current strength of the economy limits the risk of a recession. Given our concerns about a sharp slowdown, we are not sure that the Fed will succeed in reaching such and elevated peak in the policy rate.**

The Fed delivered the radical change in policy required by stubbornly high inflation and the spike in expectations. The 75bps hike recently hinted at materialised, and the FOMC plans foresee another 175bps in tightening for the rest of the year. The press release underlines the overall good state of the economy, hints at the possible stabilisation in employment and highlights the risks for the global outlook. Interestingly, the expectations of inflation returning to target (with labour market remaining strong) was replaced by the statement of the strong commitment to bring back price increase to 2% (see comparison attached).

Median projections				
	2022	**2023**	**2024**	**Longer run**
GDP growth	1.7	1.7	1.9	1.8
March projections	*2.8*	*2.2*	*2.0*	*1.8*
Unemployment rate	3.7	3.9	4.1	4.0
March projections	*3.5*	*3.5*	*3.6*	*4.0*
PCE inflation	5.2	2.6	2.2	2.0
March projections	*4.3*	*2.7*	*2.3*	*2.0*
Core PCE inflation	4.3	2.7	2.3	-
March projections	*4.1*	*2.6*	*2.3*	-
Appropriate path for the policy rate				
Federal funds rate	3.4	3.8	3.4	2.5
March projections	*1.9*	*2.8*	*2.8*	*2.4*

In the press conference Chair Powell explained the deviation from the guidance given at the March meeting - when another 50bps was announced - with the need to react to the bad May CPI prints and to the sharp rise in long term consumer expectations in the latest Michigan University survey. It is not usual to get critical information so close to the meeting, Powell said, so this abrupt shift in stance is likely to remain an exception.

Now FOMC members are keen to bring the policy rate in line with the neutral level as soon as possible, tightening policy while the labour market is still very strong. Another 75bps hike in July would do that, allowing then some flexibility over the final months of the year. Indeed, Powell stated that the next move will be of either 50 or 75 bps.

Most of the press conference was devoted to the explanation of the inflation dynamics and the need to bring it under control. The FOMC acknowledges the strength of the inflationary factors on which it has no control (commodities, global supply chains), but it is still convinced that the sharp and quick rate rise will cool the economy enough to avoid a recession and allow for a sharp reduction in inflation. Still, Powell called for caution in forecasting inflation in the medium run: the string of large supply shocks the economy has witnessed (Covid and reopening, war, jammed Chinese supply chains) is unprecedented but could signal the beginning of a much more instable period compared to the one ended at the beginning of 2020.

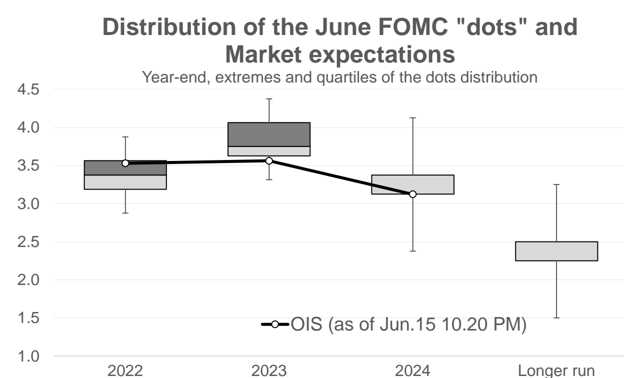
Stable inflation, Powell, repeated, is the bedrock of a functioning economy and the precondition of a healthy labour market. The expected rise in unemployment (as opposed to the very rosy outlook painted in the March projection) was acknowledged; but, at 4.1%, unemployment rate at the end of 2024 would be still low by historical standards.

Economy, according to the FOMC, is strong enough to withstand rate rises. Despite the disappointing May retail sales, the outlook for consumption remains positive. The current level of the policy rate is clearly not a drag for the economy, and Powell signalled thar real rates are still negative at the short end of the curve.

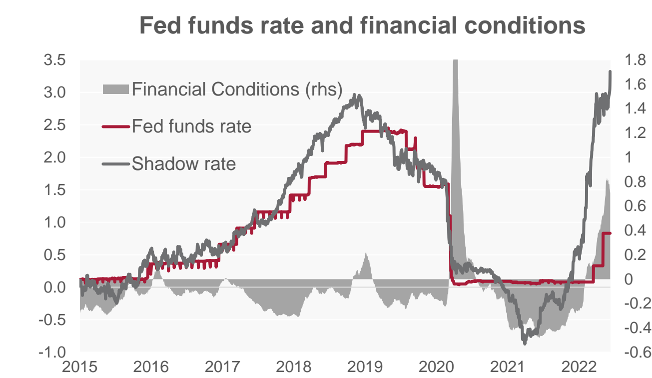
Powell pushed back against allegations that the Fed is losing credibility. In particular, he pointed to the fact that, despite the rise in rates has just started, financial conditions have already tightened significantly, as market participants take seriously yhe Fed commitment on inflation.

We are revising our Fed call in light of the meeting: we expect that the cooling of the economy and better news on inflation in the second half of the year will lead the Fed to a slower pace of tightening in H2. However, we are much less sanguine than the FOMC about the risk of a recession next year, and therefore on the peak level of the policy rate that the economy can tolerate.

After the announcement, markets revising down the extreme pricing for the YE finds rate, from a peak of nearly 4% to 3.5%. At the same time, the yield on the 10 yr Treasury retrenched to 3.3%.



Source:Federal Reserve Board, Datastream,GIAM estimates



Source:Fed Board, Datastream, GIAM

This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio has obtained from sources within and outside of the Generali Group. While such information is believed to be reliable for the purposes used herein, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. The information, opinions estimates and forecasts expressed in this document are as of the date of this publication and represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. It shall not be considered as an explicit

or implicit recommendation of investment strategy or as investment advice. Before subscribing an offer of investment services, each potential client shall be given every document provided by the regulations in force from time to time, documents to be carefully read by the client before making any investment choice. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio may have taken or, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein provided. Generali Insurance Asset Management S.p. A. Società di gestione del risparmio relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible damages or losses related to the improper use of the information herein provided. It is recommended to look over the regulation, available on our website www.generali-investments.com. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro Italiche. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..