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Soft Landings, Hard Choices

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This week the Federal Reserve raised interest rates by 50 bps at its December meeting, following four consecutive increases of 75 bps. That brings 2022's number of hikes to seven. The Fed funds rate target now stands at 4.25% – 4.50%. It had begun the year at zero.

Critics worried the Fed took too long to grasp the systemic nature of inflation when it announced its abandonment of "transitory" over "permanent" as a descriptor of higher prices last November. Delay, they feared, would make it more difficult to get ahead of inflation without a rapid uptick that would throw the economy into a recession.

Regardless of how early or late the response, as our *Chart of the Week* depicts, this has been the fastest ascent in decades. We are closing in on the 5% terminal rate suggested by recent minutes as being the point at which a pause in hikes would be considered.

Fed officials seem divided on where to go from here. Some fear that too high rates will shut down credit markets and inhibit consumer spending. Others are mindful that failure to aggressively suppress inflation now will lead to higher prices becoming entrenched in the economy. This lack of a unified front has sowed confusion in the markets overall.

This week provided important data on the direction of the economy. Tuesday's CPI report showed inflation for November eased to 7.1% from a year ago. That compares to October's number of 7.7%. Core CPI was also down from 6.3% to 6%. Core CPI was up only 0.2% from the prior month, translating to 2.4% annual inflation – not far from the Fed's target.

December's hike of 50 bps was signaled weeks ago. The question is whether this dovish data alone will be sufficient to encourage an even more modest response – say, 25 bps – at the Fed's February meeting.

This is an important consideration because a terminal rate much higher than 5% is likely to result in a harder landing. It also sets the tone for a very different discussion on future default rates and potential portfolio losses.

The soft landing scenario is now getting more support than one would have expected not long ago. Back when 75 bp jumps were first instituted, economists were pointing out that the Fed had rarely engineered such fast tightening without tipping into a recession. But the continued strength of the labor market combined with slowing inflation elsewhere is compelling.

Playing this out a bit, if by mid-year 2023 the high terminal rate is having its desired effect we could start having conversations about, unbelievably, rate cuts. Knowing how markets anticipate these developments, the new year might gain new deal energy sooner than anticipated.