

The Fed's much-anticipated policy meeting this week contained few surprises and, in more certain times, would probably have elicited a mild response in the financial markets. But these are not certain times, and lethargy was hardly how you would describe market activity following the FOMC confab. In one of the more gut-wrenching gyrations in recent memory, stock prices embarked on extreme roller-coaster intraday rides, driving the S&P 500 index into correction territory early Friday before a robust late-day rally lifted it back to within 10 percent of its record high. Fixed-income investors were somewhat less agitated, as credit spreads barely changed and long-term market rates increased modestly, albeit against a steeper increase in short-term rates.

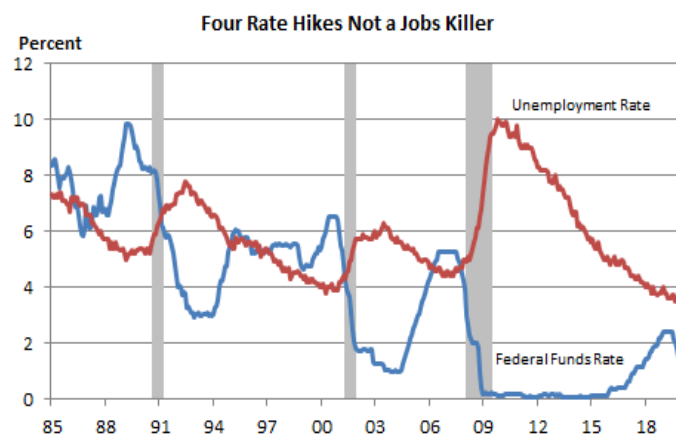
It's hard to decipher what all the fuss was about, given that the Fed delivered more or less what it telegraphed in advance. The economy no longer needs its training wheels to get on track; the job market is as close to full employment as possible in this pandemic-riddled environment, and inflation is gaining traction by the day – and tops the list of public concerns – all of which undercuts the need for monetary support. This is not fresh news as Fed officials have been saying as much for months; the message conveyed at the meeting that they are poised to terminate the bond-buying program (QE) by March and start hiking interest rates shortly after that merely confirms expectations.

That said, within an eyelash of hearing the news, the speculation machinery revved up with a dizzying array of possibilities roiling the markets. Although Fed Chair Powell did not specify how many rate hikes are in store, the market is pricing in at least four quarter-point increases this year, which is roughly in line with the Fed's signal. However, this prospect has spurred a good deal of skepticism among economists and many market analysts. Some believe the Fed is too far behind the curve, and a more aggressive tightening will be needed to bring inflation under control. Others are just as firmly convinced that the economy could not withstand even four rate increases, contending that it already faces a number of severe headwinds from the pandemic and a deep fiscal drag. At the two extremes are those who believe that inflation will recede on its own once the pandemic runs its course and those who believe that inflation has become so entrenched that only job-killing rate hikes would bring it down to the Fed's 2 percent target.

Given the wide range of possibilities, the Fed's expressed desire to remain nimble rather than go on a preset course of action, as it had in the previous rate-hiking cycle, clearly makes sense. From our lens, the March rate lift-off followed by three more increases this year appears to be the most appropriate scenario given the likely path we see for the economy and inflation over the course of the year. Importantly, that degree of tightening – leaving the Fed's policy rate 1 – 1 ¼ percent higher at year's end than it is now – is not likely to bring the economy to its knees, much less stifle job growth. Recall that the Fed raised its short-term policy rate nine times from near zero in December 2015 to 2.5 percent in December 2018. Yet the unemployment rate fell steadily from 5.8 percent to 3.7 percent during the period and continued to fall until the pandemic hit in 2020.

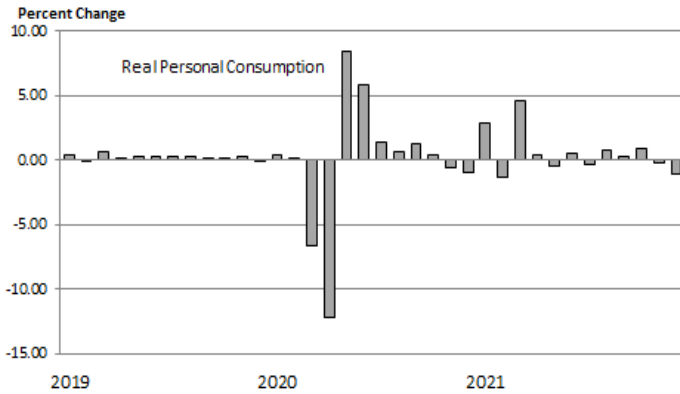
Looking further back at the three previous rate-hiking cycles, the unemployment rate did not reach a trough until the Fed increased the federal funds rate by 3.5 percent in the late 1980s, 2 percent in 1999-2000, and 4 ¼ percent in the 2004-2006 cycle. Much steeper rate increases were needed in the tightening cycles of the late 1960s, 1970s, and early 1980s because inflation was much more virulent and required harsher measures to bring under control. Indeed, with inflation now running at the fastest pace since the early 1980s, the argument that steeper rate hikes are needed than currently planned has some support. Keep in mind that the projected year-end funds rate at just over 1 percent would still be well below anyone's forecast of inflation. With real rates still negative, it is hard to argue that monetary policy has entered the growth-stifling phase. In all four of the previous rate hiking cycles, real rates turned positive before the trough in the unemployment rate was reached.

To be sure, in his post FOMC press conference this week, Powell did not push back on the prospect that a more aggressive approach might be needed, noting the upside risks to inflation that underscore the hawkish tone of his remarks. Clearly, incoming news on the inflation front is not encouraging. The Fed's preferred inflation gauge, the personal consumption deflator, ended the year 5.8 percent above its year-earlier level, and the core PCE deflator clocked in at 4.9 percent, both considerably above the Fed's 2 percent target and marking the fastest inflation rate since the early 1980s. These readings from the monthly income and spending report put an exclamation point on the



inflation trend depicted in the GDP report released the previous day, in which the annual increase in the PCE and core PCE deflators hit 5.5 percent and 4.6 percent, respectively, in the fourth quarter of last year.

Consumers Close Wallets at Year's End



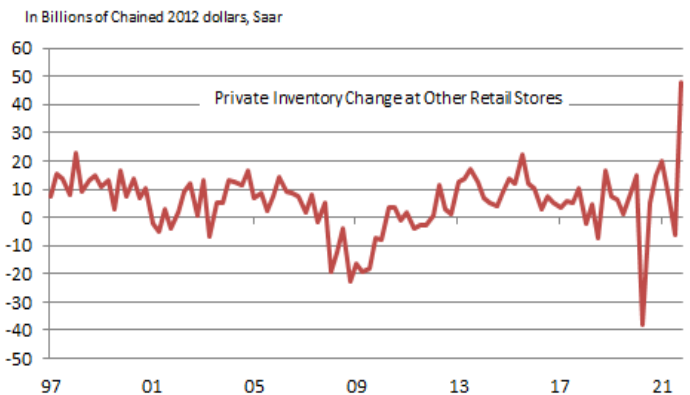
But even as inflation ended the year on an accelerating note, the monthly data on income and spending indicate that the real economy was losing momentum, putting the conundrum facing the Fed in stark relief. At this juncture, Powell’s emphasis on curbing inflation over sustaining growth reflects the widespread perception that the Omicron variant is primarily responsible for the current slowdown. And while it is also temporarily amplifying price pressures by contributing to bottlenecks and labor shortages, inflation is spreading more widely through the economy and threatens to persist even after Omicron recedes. With the job market drum-tight, labor costs accelerating, and activity expected to rebound when the pandemic’s grip on the economy loosens, the Fed is understandably more inclined to apply the monetary brakes than keep its foot on the accelerator.

While we agree that the risk of a more aggressive Fed tightening has increased, there are reasons for caution. For one, if health professionals are correct that Omicron is already cresting and poised to fade rapidly, the pandemic-related supply constraints pushing up prices should also ease, allowing inflation to start receding later this year. For another, the demand boost from a robust job market is filling a void left by the abrupt withdrawal of fiscal support this year. The fiscal drag may already be influencing spending decisions. Yes, the vast savings cushion built up over the past two years from unspent funds on services and generous fiscal stimulus payments constitutes firepower that could bolster the spending stream in the coming months.

But as we have repeatedly noted, upper-income households who have a high propensity to save hold most of those funds. Hence, the estimated \$2.5 trillion in excess savings will provide less bang for the buck in terms of economic activity than if it were held by less wealthy individuals. Indeed, there is growing evidence of financial distress among lower-income individuals since the last expanded childcare payment was made in December. According to Morning Consult, 29 percent of adults lacked enough savings in January to pay monthly expenses, a record high since the survey started in 2020 and up from 22.3 percent in December. The squeeze on household budgets is destined to get tighter from the proverbial gas tax that hits lower-income households more than others. Some industry experts expect crude oil prices to hit \$100 a barrel this year, up from the current \$87.

With the economy heading into a soft patch during the first quarter – we expect GDP growth to slow to a 1.2 percent annual rate from the fourth quarter’s sizzling 6.9 percent pace – the Fed has some time before moving more aggressively to tighten policy. By March, it will have a clearer picture of the path of Omicron, more data on the job market, and how severely the fiscal drag is impacting households. It will also have two more months of inflation under its belt. While price pressures are likely to increase during the first quarter, there are signs that supply shortages are starting to ease, including the considerable inventory buildup during the last quarter, which may pull forward the inflection point of the inflation cycle.

Inventory Pileup at Retailers



Indeed, the outsize increase in GDP in the fourth quarter owed the bulk of its strength to inventory rebuilding, which contributed 4.9 percentage points to the 6.9 percent advance, the second-largest contribution since 1987. Odds are, most of the buildup was voluntary, as companies strive to replenish the depleted merchandise they were forced to endure due to pandemic-related bottlenecks and

supply constraints. It's noteworthy, however, that an eye-opening surge took place among retailers, and we wonder how much of that consisted of delayed shipments that didn't arrive in time for the holiday shopping season. Inventory data for December is not available, but if retailers are stuck with unsold goods meant for holiday sales, there could be some heavy discounting early this year, taking some sting out of the inflation spike.

FINANCIAL INDICATORS				
INTEREST RATES	January 28	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.20%	0.17%	0.06%	0.04%
6-month Treasury bill	0.43	0.35	0.19	0.05
3-month LIBOR	0.30	0.26	0.21	0.19
2-year Treasury note	1.16	1.02	0.73	0.14
5-year Treasury note	1.62	1.56	1.26	0.75
10-year Treasury note	1.77	1.76	1.52	1.44
30-year Treasury bond	2.08	2.08	1.90	2.17
30-year fixed mortgage rate	3.55	3.56	3.11	2.97
15-year fixed mortgage rate	2.80	2.79	2.33	2.34
5/1-year adjustable rate	2.70	2.60	2.41	2.99
STOCK MARKET				
Dow Jones Industrial Index	34725.47	34265.37	36338.30	31496.3
S&P 500	4431.85	4397.94	4766.18	3841.94
NASDAQ	13770.57	13768.92	15644.97	13192.35
Commodities				
Gold (\$ per troy ounce)	1792.90	1836.10	1828.60	1742.85
Oil (\$ per barrel) - Crude Futures (WTI)	87.31	84.83	76.10	62.30
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (December) - 000s	811	725	649	714
Durable Goods Orders (December) - % chg.	-0.9	3.2	0.1	0.6
Real GDP (Q4) - % change, Saar	6.9	2.3	6.7	10.1
Personal Income (December) - % change	0.4	0.5	-1.0	0.3
Personal Consumption (December) - % chg	0.6	1.4	0.6	0.8
Savings Rate (December) Percent	7.9	7.2	7.1	8.4

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