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COMMENTARY

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The Fed Speaks and Markets Rally

- As expected, the Fed hiked the Fed Funds rate by 0.50%.
- Stocks rallied on news the Fed is not actively considering 0.75% rate hikes.
- Risks remain though as inflation factors persist.

The Federal Reserve continues to be investors' center of attention. The Fed wrapped up their two-day FOMC meeting on Wednesday and hiked the Fed Funds rate by 0.50%, as expected. In addition, the Fed started letting its assets shrink by not reinvesting all the funds it receives from maturing bonds it owns. Overall, the Fed followed through with its plans it telegraphed in March. Equity investors responded favorably to this along with Fed Chair Jerome Powell's post-meeting comments that future 0.75% rate hikes are not actively being considered. The S&P 500 finished up nearly 3% on the news.

With the most recent rate hike, this leaves the Fed Funds rate in a targeted range of 0.75% to 1.00%. Powell suggested the Fed is looking to hike rates an additional 0.50% in each of the next two meetings. That would put the range at 1.75% to 2.00% by the end of July, and give the Fed room for possibly another couple of 0.25% rate hikes in the final months of 2022. This is in line with market expectations as the CME FedWatch Tool, which estimates Fed Funds probabilities, has an 86.3% probability of the Fed Funds rate being 0.25% above or below 2.50% by year-end and close to where it was at the peak of the prior rate hike cycle in 2018.

Obviously, inflation is a lot higher than it was at the end of the last cycle. Year-over-year inflation (CPI) was 8.5% in March 2022 and barely above 2% before the pandemic. The good news is inflation is widely expected to fall, but risks to this outlook remain. Many of the factors contributing to high inflation endure. China continues to increase COVID-19 restrictions, which will only add to supply-side disruptions as U.S. manufacturers will have difficulty getting products and parts needed to sell goods. Additionally, the war in Ukraine continues to add pressure to energy and commodity prices. In the labor market, there are over 5 million more jobs than unemployed individuals looking for work. This adds to wage inflation pressures which tend to be more sticky and less temporary. The clear bright spot regarding inflation concerns is base effects. Inflation changes will be calculated off a higher price level going forward. The other argument supporting moderating inflation is slower economic growth. Last week's GDP release showed a contraction in the U.S. economy in the first quarter. While the factors driving the economic growth lower in Q1 weren't driven by declining consumption and business investment, a tempered pace of economic growth with slower goods demand could contribute to lower inflation. With that said, one could argue that economic growth and inflation do not necessarily go hand and hand as we saw in the 1970s when we saw stagflation, or low economic growth and high inflation.

Powell and markets seem confident the Fed can hit a "soft landing," taming inflation while normalizing Fed policy, but as we discussed in the previous paragraph, risks around this soft landing are high. As such, we expect market volatility to remain elevated as inflation continues to run hot and the Fed normalizes monetary policy. Investors and the Fed may be on the same page with their expectations now, but hot inflation could change that. The two-year Treasury yield has fallen off its highs, which implies the Fed may not hike rates as fast as investors originally anticipated. Inflation does seem to be easing as rent inflation and used car prices are slowing and there are signs of supply chain improvements. We will continue to watch inflationary pressures closely.

Uncertainty is high and investors and the Fed will be forced to adjust expectations as new data emerges. It is important to work with your financial advisor to help navigate through periods of volatility. We continue to recommend a diversified allocation to help dampen volatility risk.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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