

**NOTE FROM THE CIO**

Post Fed Autopsy:  
What Happened?  
What Changed?

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## Post Fed Autopsy: What Happened? What Changed?

These are the two questions that investors should be asking themselves after Wednesday's FOMC meeting. The equity and rate markets rallied after the statement was released at 2PM EST, but then quickly reversed course as Chair Powell spoke during the press conference. Let us analyze the substantive changes (if any) of monetary policy that occurred, and what the investment implications from the shift may be.

### What Happened?

As expected, the US central bank raised the Fed Funds rate by 75 bps to a target rate of 4%. The FOMC statement was on the dovish side as it suggested the Fed will be reducing the pace of rate hikes at successive meetings by inserting new language into the communique. Quoting the FOMC, "In determining the pace of future increases in target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." In other words, the Fed acknowledged that their tools work with a lag, risks are two-sided (i.e., inflation vs. growth is a trade-off), and much financial tightening has occurred already. This means that the FOMC should only raise rates by 50 bps during the December meeting. The doves in the committee made themselves heard. Subsequently, yields fell, and equities rallied.

Once Chair Powell began his press conference, it quickly became apparent that he wanted to sound hawkish to balance the statement. Tellingly, he repeated that there is still "a ways to go" to get rates to sufficiently restrictive territory. He signaled that while the pace of hikes may decelerate, they may end up higher than

previously expected. The culprits are the resilient US labor market and the stubbornly high inflation prints, which mean that a restrictive rate may be higher than they previously anticipated. In September, the Fed’s projection was for a terminal Fed Funds rate of 4.75%. Powell intimated yesterday that it could end up at 5% or 5.25%. Currently, the market is caught right in the middle at 5.13% by June 2023. We will find out what their expectation is of the terminal rate in December when the dot plots are released.

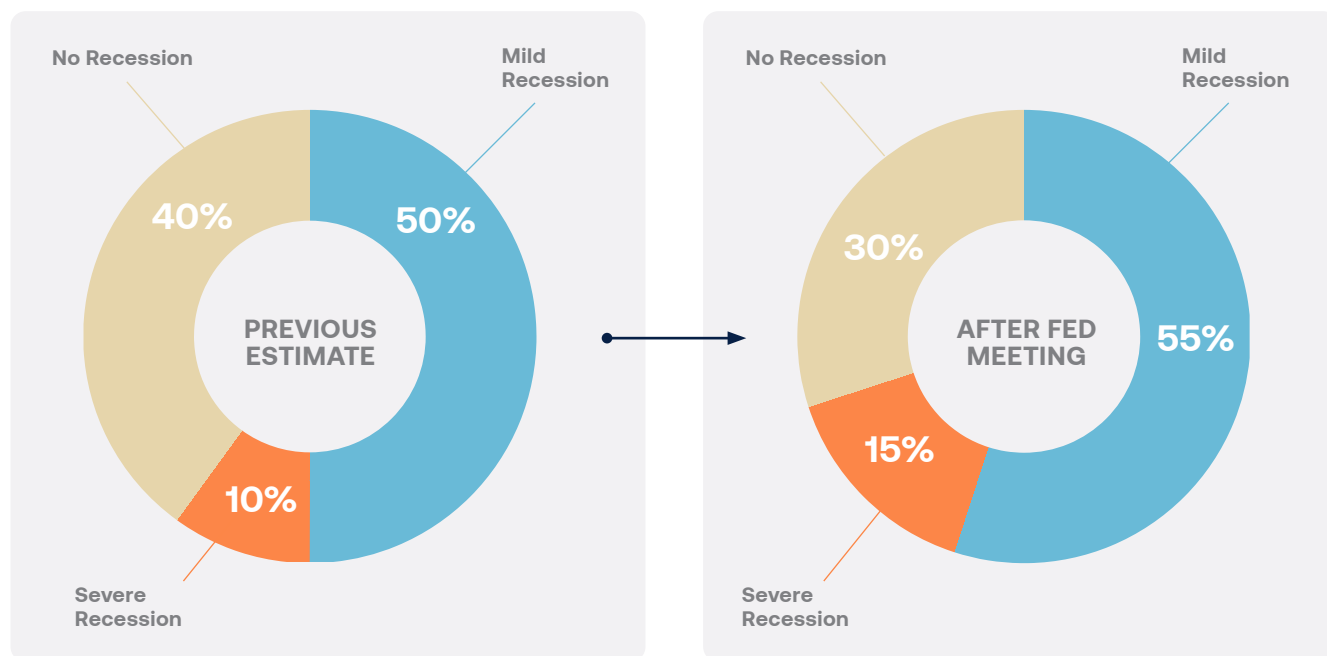
**The hawkish tone of the press conference trumped the earlier dovish statement.** In other words, the higher terminal Fed funds rate more than offset the slower pace of rate hikes. Consequently, financial conditions tightened further as rates sold off and equities turned lower in sympathy. The message for investors is that hope of a “pivot”, either a pause or rate cut, is still premature. Of course, Chair Powell can espouse this idea today with unemployment so low. It is quite another thing to do so once the employment

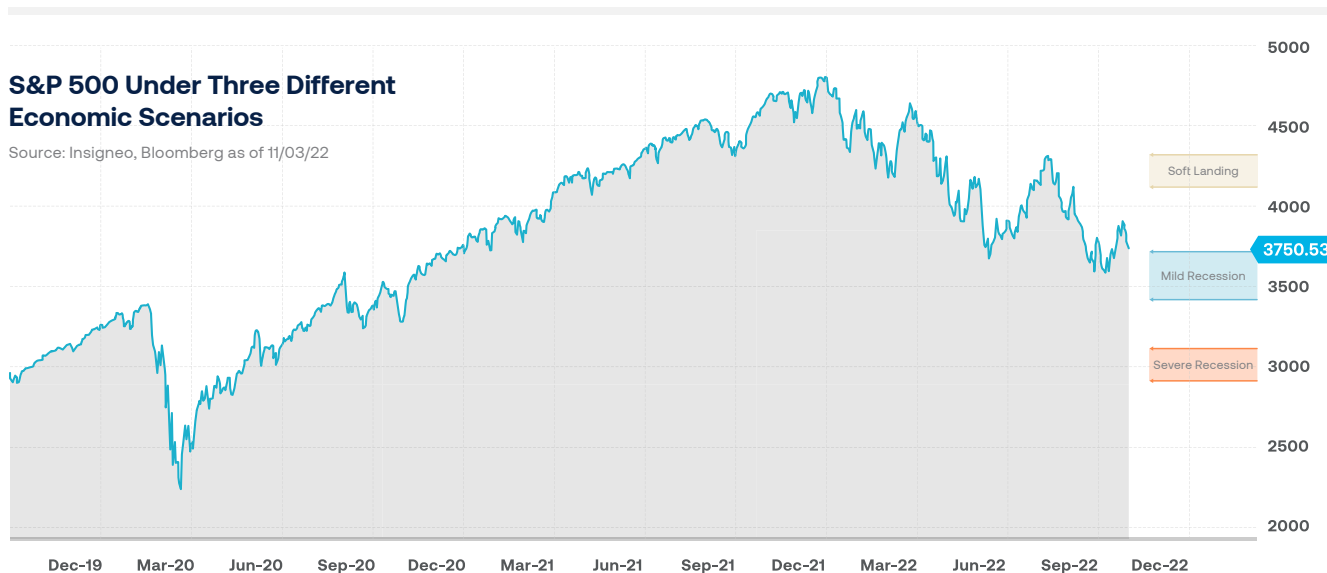
data begins to deteriorate, as it should shortly, and the political pressure mounts. If you do not think the Fed is responsive to political pressure, recall how quickly Powell himself “pivoted” after he was reconfirmed by the US Senate. Remember, there are doves within the Committee that got the softer language into the statement.

**What Changed?**

According to our Q4 projections released in September, not much. With the Fed squarely focused (at least publicly) on inflation, **the probabilities of a “soft landing” have decreased, in our view.** Chair Powell admitted as much during the press conference when, at the end, he said that the chance of a soft landing has fallen because inflation has not come down as quickly as they hoped it would. As illustrated in this graph, this is reflected in our revised subjective probabilities of a US recession over the next six

**Insigneo’s Subjective Recessionary Probabilities** | Source: Insigneo





months. Our base case was always a mild recession. That probability has gone up from 50% to 55%. The odds of a severe recession (i.e., an unemployment rate above 6%) have similarly increased from 10% to 15%. Both of the increases have come at the expense of the no recession or soft-landing scenario which fell from 40% to 30%. For US equities, our S&P 500 target ranges remain unchanged. As of today’s writing, the index is trading just above our target range for year-end, suggesting that weakness should persist, but it should be limited from here. The index target graph herein is the same as the one we published back in September. The only change is that it reflects market action since then. For rates, we remain neutral. Yesterday’s meeting likely pushes further out our date of turning bullish on rates and credit. ■

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