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# Are the markets declaring victory too soon?

## Financial conditions have been easing even though the Fed still likely has a ways to go to reach the end of this Fed cycle.

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### KEY TAKEAWAYS

- Economic growth has weakened, and inflation shows signs of peaking.
- The markets have priced in "Peak Fed," which have caused financial conditions to ease.
- The Fed may start to push back on this as declaring victory too soon. The Fed still has more than a percent of rate hikes to go, according to the forward curve.
- An open question is whether the Fed will revert policy back to neutral (2.5%) after this rate cycle.

With a 75 basis point rate hike in late July, the Federal Reserve (Fed) returned monetary policy to its definition of neutral. That move came on the heels of a second straight quarterly contraction in Gross Domestic Product (GDP). Then the July Consumer Price Index (CPI) headline inflation report showed easing more than expected, and inflation expectations (measured by TIPS breakevens)[1] fell.

With the Fed's tightening campaign apparently starting to restrain demand and bring down inflation, the markets breathed a sigh of relief. The S&P 500® recovered from bear market to correction territory, and the Bloomberg Aggregate Bond Index pared its losses as well.

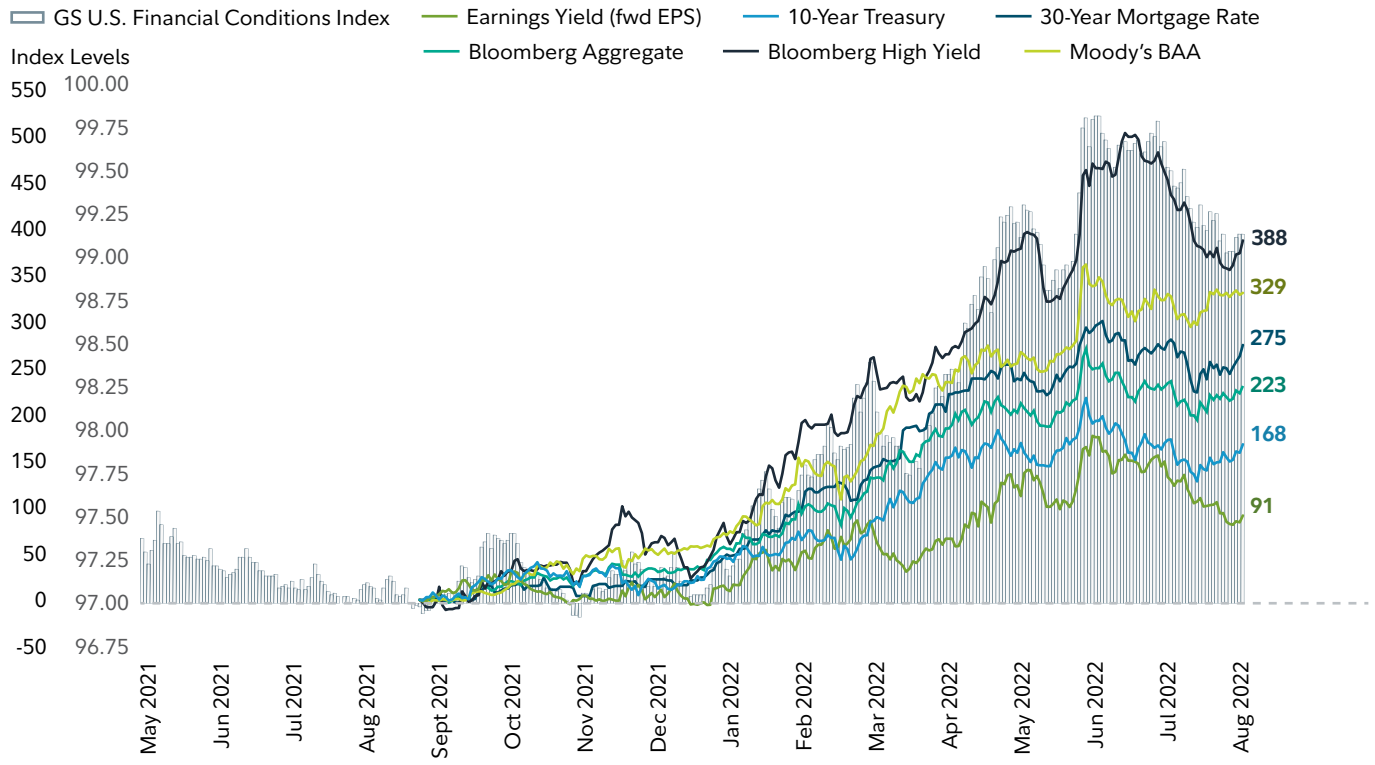
The relief rally is understandable, and it may prove justified if we manage to avoid anything worse than a "technical" recession characterized by two consecutive quarters of negative GDP growth (as opposed to an official recession as defined by the National Bureau of Economic Research, which considers a broad range of factors, including the still-hot job market).

How far beyond neutral will the Fed go? The markets currently expect the Fed to raise the federal funds rate from its level of 2.5% to a terminal rate of 3.6%, and then to cut by 100 basis points. In other words, the market expects the Fed to overshoot neutral for only a short time. Whether those expectations prove accurate will have big implications for the markets' future direction.

In effect, investors have declared the "all clear," when in fact the Fed is not done tightening. Ironically, the markets' gains threaten to undermine the very inflation-fighting progress investors were celebrating. The rally brought down the cost of capital dramatically from June through July (Exhibit 1). Capital costs have increased a bit since—but they still may be lower than the Fed would like.

**EXHIBIT 1: Has the cost of capital fallen too far for the Fed?**

Change Since September 2021 (Basis Points)

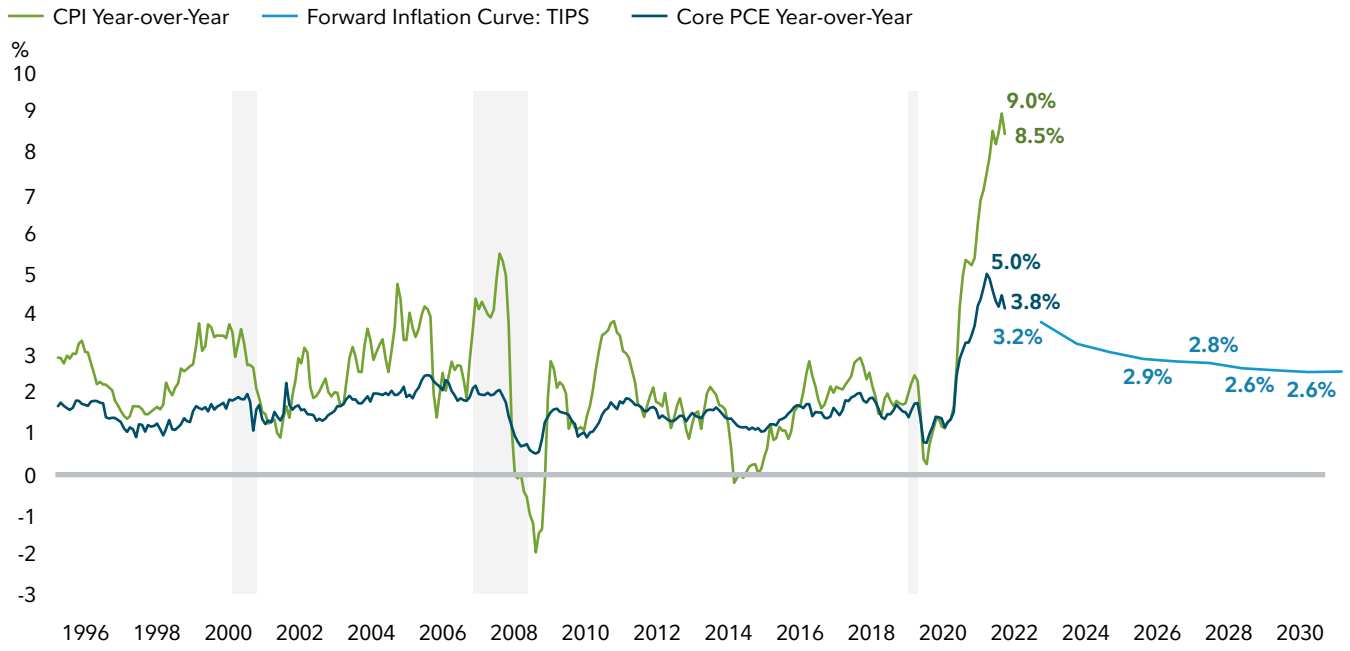



Past performance is no guarantee of future results. Goldman Sachs Financial Conditions Index is a weighted average of riskless interest rates, the exchange rate, equity valuations, and credit spreads. Earnings yield: Consensus next-12-month earnings for S&P 500 companies/S&P 500 price. 30-year mortgage rate from Bankrate. Average yields on the Bloomberg U.S. Aggregate Bond Index, the Bloomberg U.S. High Yield Index, and the Moody's BAA Index. The Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The Bloomberg U.S. High Yield Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Moody's BAA Seasoned Corporate Bond Yield is an index representing corporate bonds with credit ratings in the middle of the investment-grade range. Source: Fidelity Investments, FactSet, Haver Analytics, as of July 31, 2022.

The TIPS market is predicting a return to 2.5% inflation, which is in line with the Fed's long-term inflation target (Exhibit 2). How right or wrong the bond market turns out to be will be critical. To the extent the TIPS market is right in expecting inflation to keep cooling, the Fed may finish tightening at the expected 3.6% terminal rate and then ease back to neutral. That scenario offers the best odds for a soft landing. But if high inflation proves considerably stickier than TIPS project, the Fed may need to tighten more than expected before ending its campaign. In that case, subsequent rate cuts are more likely to be of the "we just started a recession" variety.

**EXHIBIT 2: TIPS investors anticipate big declines in inflation.**

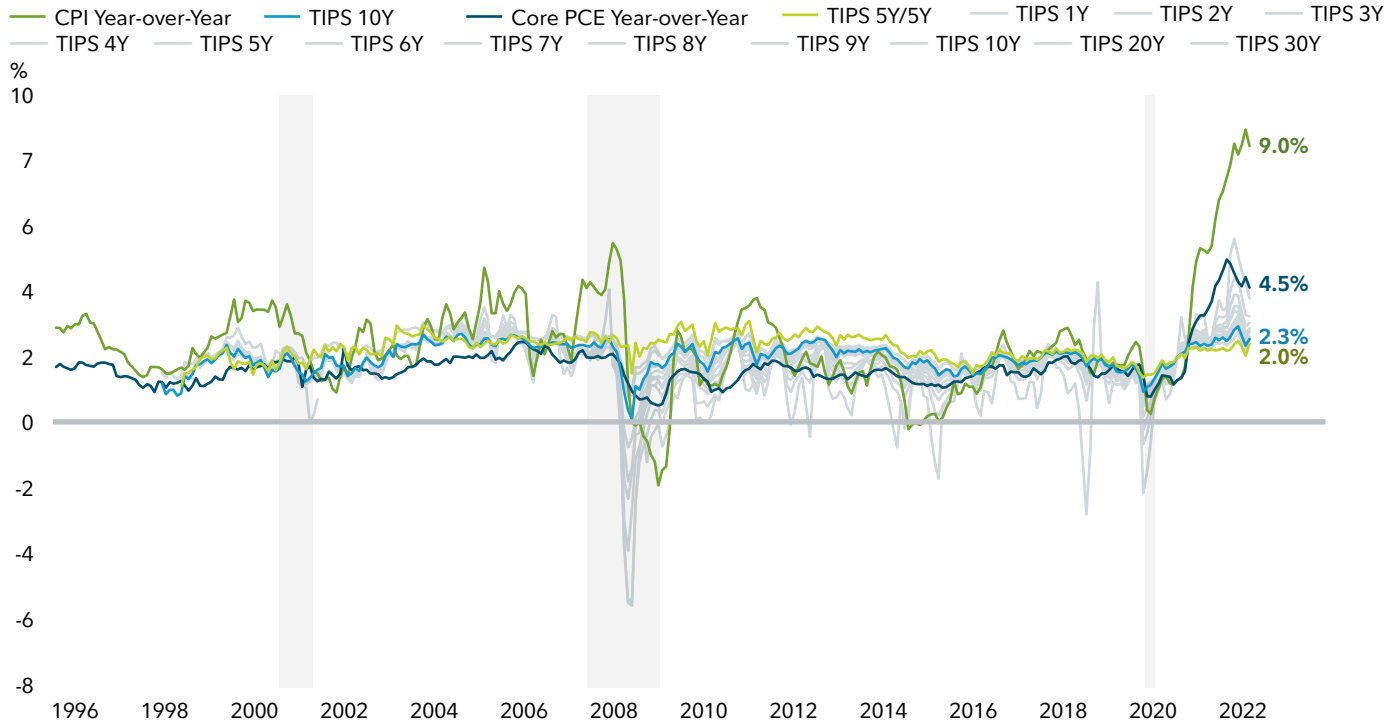
TIPS Forward Inflation Curve versus Headline Inflation and Core Personal Consumption Expenditures (PCE)




Past performance is no guarantee of future results. Shaded bars represent recessions. CPI YoY: 12-month change in the Consumer Price Index. Core PCE YoY: 12-month change in the core PCE deflator, an index of consumer expenditures that excludes food and energy. TIPS forward inflation curve illustrates the inflation rate implied by the pricing of TIPS with various maturities. Source: Fidelity Investments, as of July 31, 2022.

**EXHIBIT 3: Will inflation converge to breakevens or vice versa?**

TIPS Breakevens versus Headline Inflation and Core PCE, 1996–Present




Past performance is no guarantee of future results. CPI YoY: 12-month change in the Consumer Price Index. Core PCE YoY: 12-month change in the core PCE deflator, an index of consumer expenditures that excludes food and energy. TIPS 5Y-5Y: The TIPS 5-year 5-year is a measure of inflation expectations, showing the difference in expected yields on a 5-year TIPS and a comparable Treasury. Source: Fidelity Investments, as of July 31, 2022.

Exhibit 3 compares various TIPS breakevens (5-year 5-year) with headline CPI and core Personal Consumption Expenditures (PCE); PCE excludes volatile food and energy prices. As you can see, these metrics have tended to converge over time. Perhaps CPI and the core PCE deflator have started to converge down toward TIPS breakevens. If that trend continues, the Fed may be able to cease its tightening trajectory before policy becomes overly restrictive. On the other hand, TIPS breakevens may move up toward the inflation indicators, forcing policymakers to extend their campaign.

How will the cycle end? The Fed wants to tighten enough to bring core inflation back down to 2% without choking off economic growth altogether. Inflation seems to be heading in the right direction—for now—while the growth outlook is mixed.

As of now, it looks like the Fed might bring the federal funds rate to a terminal rate of 3.6%. Hiking to that point, along with an additional percent or so of tightening in the form of quantitative tightening, would take us into a classically restrictive range (about 2% above the Fed's estimate of neutral). Hopefully, that degree of tightening will prove high enough to return inflation back to the Fed's target without breaking the economy much further. I'll be watching TIPS breakevens carefully to see whether the Fed's endgame is truly in sight.

## Author

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Jurrien Timmer is the director of Global Macro at Fidelity Investments. In this role, Mr. Timmer specializes in asset allocation and global macro strategy. Additionally, he is responsible for analyzing market trends and synthesizing investment perspectives across Asset Management to generate market strategy insights for the media, as well as for Fidelity's clients.

*Fidelity Thought Leadership Vice President Martine Costello Duffy provided editorial direction for this article.*

**Endnotes**

[1] The breakeven rate for Treasury Inflation-Protected Securities (TIPS) is the difference in the rate of a nominal Treasury security of the same maturity as a TIPS security.

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**Moody's BAA Seasoned Corporate Bond Yield** is an index representing corporate bonds with credit ratings in the middle of the investment-grade range.

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