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Who is in Charge?

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Inflation in the US is large in scale, broad in scope, and increasingly built into people's expectations. Seeing inflation soar beyond the 1-to-3 percent comfort zone that had prevailed for about thirty years, Federal Reserve (Fed) officials now apparently appreciate that they have work to do returning it to their goal, the center of that range at 2 percent. They may have perhaps started the job a little late, but they are tackling it in earnest, at least for now as judged by the most recent Summary of Economic Projections (SEP). In the June "dot" plot, Federal Open Market Committee (FOMC) participants expect the appropriate policy rate to be near 3 ½ percent by the end of this year and close to 4 percent next. The immediate plan is to get there in a hurry, with chunks of ½- and ¾-percentage-point hikes at the next few FOMC meetings according to the latest FOMC minutes.

With employers adding just under 400,000 workers, on net, over the past four months and consumer price inflation hitting 9.1 percent on an annual basis in June, we believe Fed officials will opt for the latter, super-sized move at the meeting scheduled for July 26 to 27. Other market participants concur about a large action, putting about a 3-in-10 probability on a 75 basis-point hike and a whopping 7-in-10 chance on a full percentage point increase, according to futures market prices just after the consumer price print.

We think a full percentage point increase is a bridge too far. However, the sentiment is understandably influenced by the last FOMC cycle when the Fed relied on back-channel guidance to up the ante from 50 basis points to 75 basis points at the last minute. Chair Powell has demonstrated close to a religious conviction in avoiding market surprises on FOMC announcement day, probably because untoward financial price movements in response to the FOMC announcement at 2:00 p.m. (Washington, D.C. time) could turn his press conference that starts one-half hour later quite ugly. This fixation with not surprising the public is tailor-made for creating a self-reinforcing outcome.

Market participants know Fed policy action will be at one of two corners, three-quarters or one percent. The weight of their movement to one (reflected in short-term interest rates) makes vacillating officials more likely to go to that outcome, so ever more investors pile on to that bet, whether or not the initial swing in sentiment is well informed. In this environment, when pricing is split between two possibilities, Fed officials are going to have to signal which one is right. Recent Fed speakers all swam up to a ¾ percentage point move, but that was before the inflation surprise, and there is still time for them to right the boat before the speakers' blackout curtain drops if the one-point move is their desideratum. Given precedent, if the situation hasn't settled by then, expect some back-channel revelation thereafter to drain any element of surprise from the actual meeting (as the chair apparently has the right reporter's phone number on his speed dial).

Call us old fashioned, but we harbor the possibility (perhaps it is merely a hope) that Fed officials care about doing the right thing rather than be led along the front end of the yield curve by investor sentiment. They had an organized discussion at the last meeting about two possibilities in which they also signaled a large net movement by year-end. The larger of the two they discussed at that time, 75 basis points, gets them there quickly, especially if associated with the commitment in their joint statement that more such moves are to follow, and reinforces the importance of Committee consultation. An audible by the chair this late in the game raises questions about the game plan, demonstrates that the Fed follows, not leads, and puts outsized importance on a single data print. That is, we still have penciled in a ¾ percentage point move in our forecast, but only in pencil given officialdom's capacity to disappoint.

The ultimate destination for the nominal funds rate, of course, depends on the evolution of the economic outlook, particularly on how officials balance their dual objectives of price stability and maximum employment as progress in reducing inflation remains fitful and economic activity teeters on the brink of recession. This will challenge Fed officials more than they are willing to admit. In our forecast, belying the Fed's public optimism, inflation is slow to fall because aggregate supply only hesitantly fills in, workers seek sizable wage increases to catch up for lost purchasing power, and the public remains concerned about a changeable price level. As a result, the "dot" plot is a lower bound to the likely policy rate. With further significant rises in the funds rate in the offing, we feel the economy will almost surely fall into recession within the next twelve months. We doubt that the Fed will get the mix right by stopping short of returning inflation to its goal when it veers to recession fighting next year. That is, we believe inflation will remain a persistent problem.

Chair Powell's aversion to surprises sucks the excitement out of Fed Day as he mutes mentioning differences of opinion and concerns about specific risks among policymakers. There are three concerns that will be hard for him to avoid whispering:

- Does he admit that the inflation outlook is worse than in the June forecast without overemphasizing one data point? (That was the March-May-June sequence.)

- Does he extend the recent trend of more acceptance of (almost resignation toward) recession risk?

- What is Powell's view of financial conditions—tight or tightening? The latter emphasis would signal that the Fed needs more of an asset-price selloff to achieve its forecast of a slowing in demand.

The EUR/USD and the Possibility of Official Intervention

Two once-in-a-century shocks—a global pandemic and a large-scale land war in Europe—have confronted this generation of economic policy makers. The Euro area has had an uneven pandemic, is closer to the conflict, and relies more on the combatants for commodities. The European Central Bank (ECB) was accommodative even before the shocks and has extended this stance since, during which the macro interest of northern Europe in stimulating demand mostly aligned with the micro interest of southern Europe in suppressing rate spreads. The Fed's move to reclaim some of the ground lost in its pursuit of price stability left the ECB out of sync among many of its peers and Eurodollar interest rates relatively unattractive in global capital markets, fostering depreciation of the value of the euro on foreign exchange markets.

Even as the European Central Bank has pivoted toward firming its policy guidance, narrowing the interest rate gap among medium- to longer-term maturities, the euro has weakened further against the US dollar. This probably owes both to the likelihood domestic inflation will stay elevated given the erosion of purchasing power on exchange and commodity markets and to the near certainty of economic recession. Such outcomes will strain national and private balance sheets, but in an uneven manner among the members of the Euro area that blunts some of the support to the value of the euro from ECB firming. Important in determining the path of the euro on the foreign exchange market, and as yet unknown, will be the ECB's "anti-fragmentation" efforts to limit the widening of sovereign spreads, a program that is potentially both politically and constitutionally fraught. We believe the forces pulling the value of the euro down will dominate for a bit and the currency will trade below parity with the US dollar.

The prior time the euro visited that neighborhood (in 2000) elicited concerted foreign exchange intervention in its support. However, the overwhelming opinion of academics and economic officials (the latter importantly influenced by the Jorgensen Report in 1983) is that sterilized intervention has only marginal effects on foreign exchange values in advanced markets. This is an opinion still likely shared among US economic officials, where those at the Treasury have the final say. (Both the Fed and Treasury would use their joint resources in markets if the time comes.) Such consent is rarely given, as there have been only three episodes of US foreign exchange intervention since 1995. Given prevailing views, intervention decisions are as much about the coordination of foreign policy as economic policy. If Euro area officials broach the subject at a high level, US officials will listen but probably with considerable skepticism. The optics of exchange market intervention by the Fed and Treasury to undercut dollar appreciation is problematic when inflation at home is universally viewed as the pre-eminent problem. In any event, only an action satisfying the criteria spelled out by then-Secretaries Rubin and Summers will be on the table. The Rubin-Summers doctrine is that intervention must be concerted across major economies, large in scale, undertaken by surprise, and ideally when markets are relatively thin. Never say never.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

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