



Kristina Hooper
Chief Global Market Strategist



Powell stays hawkish

Fed Chair Jay Powell reiterated his message that bringing down inflation will translate into economic pain.

Data still matters

I recognize the necessity of Powell's words, but take comfort from the fact that the Fed remains committed to being data dependent.

What comes next?

Based on the data, I expect the Fed to subtly pivot to a less hawkish 50 basis point hike in September.

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Stocks have been falling around the world in reaction to Friday's hawkish speech from Federal Reserve (Fed) Chair Jay Powell. In less than 10 minutes, Powell struck fear in the hearts of many investors around the globe, who worry what these comments may mean for September's Federal Open Market Committee (FOMC) meeting. But I believe what we saw in Jackson Hole was less of a preview of what the Fed will do next and more like the first act of a Broadway show — all of the players were following the script, but a lot could change before the curtain falls.

What happened in Jackson Hole?

As I expected, Powell was very hawkish. He talked tough, reiterating the message that bringing down inflation will translate into economic pain. He suggested the Fed is willing to drive a Mack truck into the economy in order to combat inflation: "We are taking forceful and rapid steps to moderate demand so that it comes into better alignment with supply, and to keep inflation expectations anchored. We will keep at it until we are confident the job is done."¹

Powell also stressed that the Fed is going to maintain higher rates for some time: "Restoring price stability will likely require maintaining a restrictive policy stance for some time...The historical record cautions strongly against premature loosening policy."¹

The chorus of other FOMC members also chimed in, providing very hawkish language in their interviews last week. Loretta Mester was particularly aggressive, arguing the Fed will need to take the fed funds rate above 4%.²

What's my take on the meeting?

Despite the market's initial reaction, I would give a good review to last week's show for several reasons:

- I recognize that Powell had to do what he did on Friday. The Fed needs to keep up with its hawkish rhetoric in order to continue to exert downward pressure on inflation expectations. After all, words are cheap.
- I also believe if the Fed doesn't expect to reduce rates quickly, then they have to finish at a level that is tolerable. And that in turn means they would need to make a pivot to a less hawkish stance sooner rather than later.
- But most importantly, I take comfort from the fact that the Fed remains committed to being data dependent, as Powell reiterated again last week.

What might happen in September?

Based on the data, I expect the Fed to subtly pivot to a less hawkish 50 basis point hike in September. Consider the following:

- **Inflation expectations.** Market watchers were so busy listening to Powell's speech last Friday that they may have missed the release of the University of Michigan Survey of Consumers. It showed that consumer inflation expectations are becoming better anchored in the short- and longer-term. One-year ahead inflation expectations were 4.8% for August versus 5.4% in June.³ And five-year ahead inflation expectations were 2.9% in August versus 3.3% in June.³
- **S&P Services Purchasing Managers' Index.** Last week, the reading was surprisingly bad, clocking in at 44.1 — well below expectations and the lowest reading since May 2020.⁴ This indicates a significant decrease in services spending is in the offing; in other words, the Fed has already hit the US economy over the head with a large mallet. And Powell has rightly admitted that some of the impact of recent rate hikes has not yet been seen in the data. You can file this under "bad news is good news." Now it's unlikely that this kind of data will deter the Fed from tightening, but it should increase the likelihood that the Fed will pivot to a less hawkish stance, hiking rates by 50 basis points in September and then following a softer path, with a few more 25 basis point hikes before finishing.

Of course, there will be more data before the Fed meets next. Sept. 21 is a long way away and much can happen, but I believe there is a very good chance that the Fed will subtly pivot in September. You may have heard of the "humble brag" (an expression that was rather popular with my children a few years ago) — well, I suspect you might be hearing more about the "subtle pivot" going forward.

News from China

In addition to the market's pessimism around the Fed, there has been a lot of pessimism around China in recent months. However, that seems to have changed in recent days as China announced a number of growth-supporting measures at the recent State Council meeting, with more than 1 trillion yuan in stimulus.⁵ This includes substantial funding for infrastructure investment. This could be a significant positive for the Chinese economy, countering some of the headwinds that have caused many economists to downwardly revise growth forecasts for the year.

Looking ahead

For the week, the data I will be paying close attention to includes the upcoming China PMI releases as well as reports on eurozone inflation, Canada gross domestic product, and US jobs. The reality is that every data point takes on more importance when central banks are tightening hard and fast, as we try to gauge the damage to the economy as well as the level of success in fighting inflation.

With contributions from Thomas Wu

Notes

¹Source: Federal Reserve, transcript of Jay Powell speech, "Monetary Policy and Price Stability," Aug. 26, 2022

²Source: Bloomberg, "Mester Says Fed Might Need to Move Rates Above 4% and Hold," Aug. 26, 2022

³Source: University of Michigan, Aug. 26, 2022

⁴Source: Reuters, "U.S. private sector activity contracts again in August, survey shows," Aug. 23, 2022

⁵Source: China Ministry of Finance, State Council

Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

Investments cannot be made directly in an index.

Tightening is a monetary policy used by central banks to normalize balance sheets.

A basis point is one hundredth of a percentage point.

The Federal Open Market Committee (FOMC) is a committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

Purchasing Managers' Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The federal funds rate (or fed funds rate) is the rate at which banks lend balances to each other overnight.

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