Economic Alert

Global Research
27 June 2022

Has the Fed put become a Fed call?

- **Fed rhetoric has so far brushed aside signs of weakness and emphasised inflation**
- **The Fed may not want a rally in risk and financial conditions until inflation is clearly heading down**
- **As a consequence, the Fed *put* may now be a Fed *call***

Fortune brings in some boats that are not steered

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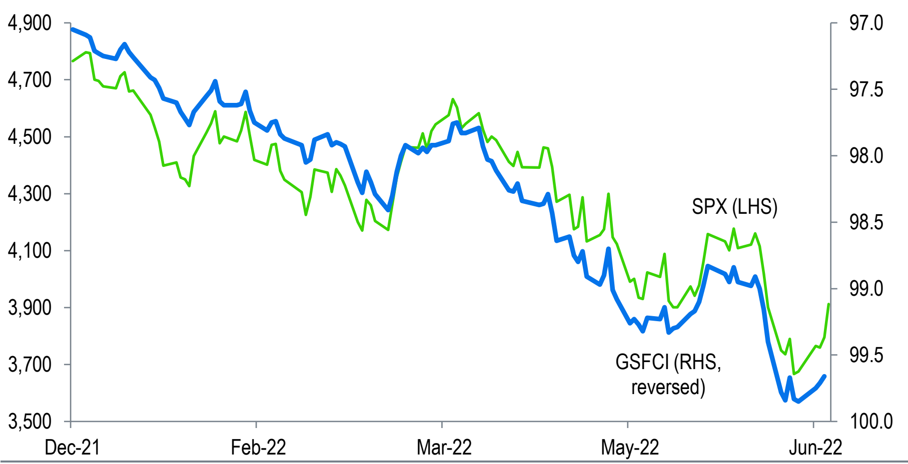
Put on your favourite Walter Mitty pose, imagine yourself a FOMC participant, look in the mirror and ask 'Did I really want to see the equity market run up 3% on Friday?". The Friday (24 June) news was that the final Michigan confidence survey erased the surge in expected inflation, which was part of the Fed's motivation for the 75bps June hike. It also quite possibly brought US financial conditions back to where they were in mid-May (Figure 1). However, few FOMC participants have shown any room to back off from the inflation fight.

If the Fed does not see evidence that inflation is turning, it may not welcome unwinds of the tough financial conditions stance that it has advocated so strongly. It may fear that an unwind in equity market weakness before clear evidence of a turnaround in inflation will reduce pressure on spending, slow the closing of the supply-demand gap, and help keep inflation undesirably high. This is the opposite of the Fed put and basically suggests that the Fed may push back against equity market gains until it is comfortable that disinflation is a lock – in other words, a Fed call.

Our forecast that the FOMC hikes 50bps at each of the next two meetings is based on a view that the economy will send enough signals of slowing activity and inflation by the 27 July meeting to downshift the hiking pace to 50bps. Markets have 69bps priced for the July meeting, clearly more convinced than we are that 75bps is likely. We think it will be a much closer call but recognise the upside risk to our 50bps call.

Figure 1: SPX implies a big improvement in financial conditions
Index (SPX, LHS); INDEX (GS FCI, RHS, reversed)



Source: Bloomberg, Standard Chartered Research

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The recent equity bounce may be unwelcome to the Fed

We have argued that the Fed is giving a softer form of guidance than in 2021, encouraging the market to price in hawkish expectations of policy rates moves and not wanting to prematurely signal a turnaround (*FOMC – A modified forward guidance framework*). In this context, we suspect that the recent bounce in equities is unwelcome to the Fed.

The Fed may want to discourage aggressive pricing of reversals

The Fed may not want to see a significant easing of financial conditions until it is virtually certain that inflation is moving in the right direction. Given how much grief the Fed is catching due to above-target inflation, Fed officials have indicated that they are unwilling to unwind tightness based on forecasts of declining inflation. While it is normal for markets to base pricing on expectations of future inflation and policy, the forward pricing makes the Fed's job easier when it is in line with the Fed's rhetoric and harder when it is opposed.

There is a Fed put to prevent financial market destabilisation

To be clear, there is a Fed put that never goes away. If the tightening of financial conditions and the drop in equity prices are so severe that there is a threat of financial destabilisation, we expect the Fed to step in. Such a put is struck well below current market levels and is more a function of speed than any particular equity market level. But that lender of last resort function is not the same as a perception that the Fed will step in to buoy equity markets to stimulate demand. When inflation is below target, it may look as if monetary policy is aiming at supporting equity markets, but that is not the case when inflation is above target.

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