COLUMBIA THREADNEEDLE INVESTMENTS

# A data-dependent Fed and future monetary policy

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*What could investors see from the Fed for the balance of 2022?*

Is there a light at the end of the rate hike tunnel? That's what many investors are wondering on the heels of last month's Fed symposium in Jackson Hole. And the answer to that question will depend on if the Fed believes it has done enough to bring down inflation. In fact, Fed officials are looking for evidence — beyond a reasonable doubt — that this year's rate increases and tightening of financial conditions will bring inflation back down to 2%. They need to see concrete data that economic growth is slowing and that the labor market is weakening.

The good news is that there are some indications that economic activity is decelerating heading into the last quarter of the year. The housing market is weakening, as decade-high mortgage rates are leading to steep declines in home sales and new home starts. Manufacturing data is deteriorating, with the ISM manufacturing index slumping to its lowest level since June 2020. However, how quickly these indicators translate into a slowdown in employment and inflation is the open question.

So far, inflation pressures remain persistent and robust, with over 70% of items measured in the July consumer price index (CPI) increasing above a 4% annualized rate. And the tight labor market has not shown any signs of cooling, with unemployment back to prepandemic levels and wage growth exceeding expectations.

## Looking for signs that the Fed's policies are working

| Economic driver | Examples of data | What is the Fed looking for? |
|---|---|---|
| **Inflation** | Headline inflation (CPI/PCE), inflation momentum, inflation expectation | Sustained deceleration toward 2% and anchored expectation |
| **Employment** | Wages, job openings, unemployment | Lower wages and higher unemployment |
| **Growth** | GDP, household consumption, manufacturing, housing market (e.g., housing starts, sales, prices) | Slowdown in household and corporate activity |

Source: Columbia Threadneedle Investments

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Because monetary policy acts with a lag, we have not yet seen the full impact of higher rates on the economy. This means the Fed must be nimble and act with little long-term insight. While one of the main takeaways from the Fed's July meeting was a supposed shift away from forecasting subsequent rate hikes (forward guidance), the Fed is continuing a pattern of reacting to data as it comes in. This "data dependence" will continue to guide Fed policy for the rest of the year, and given the magnitude of hikes over the last few weeks and decelerating growth, the endpoint for the hiking cycle is more uncertain.

Right now the Fed is fighting for its credibility. And for officials, the cost of doing too little — allowing inflation to become entrenched — outweighs the cost of doing too much. Fed Chair Jerome Powell has signaled that he will risk sacrificing employment and potentially over-tightening policy to break inflation. Therefore there must be overwhelming evidence of success before the Fed brings the tightening cycle to an end. With data currently raising more questions than it answers, the Fed is under pressure to deliver more tightening. For fixed-income investors, more tightening could mean elevated volatility, especially for shorter maturity yields. For long-term bonds, the greater risk of economic contraction could increase demand and cause their yields to fall. This would result in an even deeper inversion of the yield curve, which makes long-end exposure more attractive.

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