November 10, 2022

The Fed's tightening campaign is starting to work

In its offensive against stickier-than-expected inflation, the US Federal Reserve began its hiking campaign back in March 2022. In total, it has now increased its key rate by 375 basis points in what has been the fastest rate hike cycle in history. However, it takes time for the cumulative effect of tighter monetary policy to work its way through the economy and only now, are we starting to see convincing evidence that tighter policy is having the desired effect.

By raising interest rates, the Fed aims to temper elevated demand which has pushed up corporate activity and prices. The moderation in demand has occurred at varying speeds across sectors. In those that are highly sensitive to interest rates, such as housing, recession is already nigh. However, in other sectors, lags in transmission mean that tighter policy is only starting to have a visible effect. This helps explain why earnings expectations, which have been remarkably resilient through most of the year, have started to deteriorate. According to FactSet, on September 30, the estimated earnings growth rate for the S&P 500 in Q4 2022 was 3.9%.

Today, the estimated earnings decline is -1.0%. Anticipated margin compression squares with anecdotal evidence from PMI surveys suggesting corporate and consumer demand is waning – especially for goods.

What we have seen play out so far tallies with the classic inflation cycle which normally sees commodity prices soften first, then goods. Usually, services are next in line and then ultimately wages.

The US labour market has been problematic for the Fed, the one stubborn area where, until now, policy seemed to do little to rebalance the supply and demand for workers with unemployment hovering near a 50-year low. However, with tighter financial conditions hurting cyclical demand, very faint cracks are starting to appear. Though private employers continued to hire at a resilient pace last month (+261k jobs added), it was the slowest pace since December 2020, and micro data tells us layoffs are starting to pick up – for example, Meta just announced 11k layoffs. Nonetheless, the labour market is still "hot" with the current ratio of job openings to job seekers at 1:9 versus 1:2 before the pandemic. A tight labour market typically pushes up wages – one of the stickier inflation drivers.

Overall headline inflation has also been trending downwards, hitting in 7.7% October, quite a bit below June's peak of 9.1%. But the Fed is not out of the woods yet – it is still more than three times the Fed's 2% target and it has broadened out. As such, the Fed has to continue to make progress in bringing it down. Failure to do so would likely lead to a de-anchoring of inflation expectations and a potential price spiral.

This leaves the Fed in quite a predicament. It has to decide how much tightening is still appropriate while previous actions continue percolating through the real economy. If it doesn't tread carefully it risks overtightening, increasing the probability of a "hard landing" for the economy. It is therefore likely that the Fed takes its foot off the gas, opting to continue tightening, albeit with a "slower for longer" approach.

Such a shift would have implications beyond the US economy. The Fed is the playmaker with regard to tightening, with other central banks like the ECB somewhat forced to keep pace and prevent widening policy differentials which will weaken their currencies against the dollar and stoke inflation further. A slower Fed would likely inspire a collective sigh of relief from other central banks around the world whose economies are looking a lot less sturdy than that of the US.

Disclaimer

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timeless of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned into it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained herein this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent,- subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any: inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified. All Financial data and/or economic information contained herein can also quickly become out-of- date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of the date indicated in the matrix or the publication date. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. *This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch ı L-2953 Luxembourg ı RCS Luxembourg B-6307 ı Tel. +352 4590 6699 ı www.bil.com.*

BIL 1856