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What Tighter Monetary Policy Will Mean For a Growing Economy

By Steven Wieting and David Bailin

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With the news that the US economy added 162,000 jobs in August, the Fed lost another reason to stay on pause. The decline in jobs reported for July was also erased with these upward revisions. And in Warsh's thinking, the news that inflation slowed over the past two months doesn't erase a long stretch of inflation above the Fed's target.

Following Friday's robust jobs data, Fed funds futures price in a 62% chance of a 25 basis point rate hike on September 16. This would mark the possible start of a new Fed hiking cycle, reversing the modest cuts of 2024-2025. Ironically, the sources of inflation, including Trump-led tariffs, associated trade disruptions and the Iran War will not matter much to Warsh and company.

The fact that Chairman Warsh doesn't believe the Fed should strongly signal its intentions makes it unlikely markets will price in a high level of certainty about the outcome of the FOMC meeting. Action will "make us believers."

Fed Hikes Now Will Be Modest...

Markets currently price 50 basis points of hikes to a 4.25% upper rate peak during the year ahead. This seems a modest expectation given the state of inflation and the broader outlook for the economy. (Figure 1.)

A larger "correction" to the Fed's 2020-2022 policy mistake was already made by former Chair Powell, who hiked US policy rates from near 0% to 5.5% at peak. The Fed's subsequent decision to ease to 3.5%-3.75% helped preserve the current economic expansion.

The slowdown in post-pandemic inflation was too gradual for Warsh as he outlined at Jackson Hole a week ago (Please see last week's Point)

Higher Rates Do Not Suggest an Immediate Economic Derailment

If Warsh's Fed hikes rates the President will not be amused. President Trump attempted to fire Powell for failing to cut interest rates further than he did. He installed Fed Governor Miran apparently to drive rate cuts and looked for a time to add additional rate-cut sympathetic officials before nominating Warsh. Future disharmony is a strong possibility.

In our view, history suggests the Fed is unlikely to derail the economy with modest rate hikes from current levels. Rather, it's the future economy that will eventually send the Fed on a different trajectory.

FIGURE 1

Fed fund Target (central rate) %

SOURCE: CIO GROUP, HAVER ANALYTICS

Not since the Fed deliberately induced recessions in 1980-1982 has a firming of US monetary policy driven a contraction in the economy rapidly. Unlike 1982, the Fed's policy rate is not 14%, well in excess of the nominal rate of expansion in the economy. And the Fed is not presently restrictive. It has not made cash a more attractive return opportunity than the returns the economy generates.

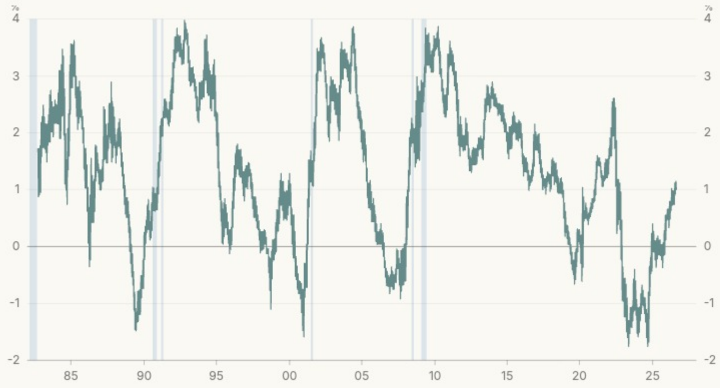
The Fed is the Economy's Demand Regulator

Unfortunately, the Fed's policy rate "catch up" is not the greatest risk to the economy. The key issue is the future course of investment spending, just as it was in the 1990s expansion that ended in 2001 (Figure 3). Investment in IT equipment is directly responsible for driving 40% of US economic growth in the past year. IT's 65% growth rate for the past 2 ½ years may continue for the coming year but cannot be sustained far longer. With the completion of data centers, spending will certainly fall, perhaps meaningfully in 2028.

At that time, the Fed funds rate may be too high for expansion to endure without rate cuts. So many financial and real economic variables are aligned with this spending. Only a marked broadening of the sources of expansion would prevent a severe economic slowdown at that time.

FIGURE 2

US Treasury 10-Year Yield Less Fed Funds Target
And Length of Economic Expansion Period Following Initial Fed Tightening



Time from Initial Fed Tightening to Recession Onset

1983-1990	88 months
1994-2001	86 months
2004-2007	42 months
2015-2020	51 months

SOURCE: CIO GROUP, HAVER ANALYTICS

The Fed cut its policy rate from 6.5% to 1.0% from 2001-2003. Tech-focused investors of the day lost the majority of their portfolios in the tech wreck. We don't believe events must follow the exact same course. However, investors do need to understand that the Fed did not cause the excessive optimism in tech investments of the time and it didn't bring about their end. The Fed also did not stop the bubble and bust from occurring with its subsequent rate cuts.

CIO Group's Portfolio Actions

Today, investors should understand the economy's strengths and vulnerabilities and take advantage of policy developments. On Monday, August 31, CIO Group raised its allocation to short-duration US fixed income 1% across portfolios, moving US equities lower by an equal amount.

With the US dollar boosted by Fed-related developments, we have stayed modestly underweight non-US equities and now neutrally positioned globally. During a period of future US rate cuts – which are unlikely in the coming year – we would look to adjust up our share of non-USD assets in portfolios.

FIGURE 3

IT Investment Spending as % of GDP.

SOURCE: CIO GROUP, HAVER ANALYTICS

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