Key Questions

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Does the Fed Want to Cause a Recession?

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No. But persistent inflation may have left the Fed with little choice but to induce one.

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Yesterday, The Federal Open Market Committee (FOMC) increased the target range for the Federal Funds rate by 0.75%, bringing the range to 3.00 to 3.25%. This decision was unanimous and was in line with market expectations.

As the market has been anticipating higher interest rates from the Fed, bond yields have risen significantly, with long-term yields up over 200 basis points (2%) and short-term yields up over 300 basis points (3%) since 2022 began. This has resulted in a tightening of financial conditions and higher borrowing costs for consumers and businesses alike.

The Fed has lifted interest rates hoping that it can sufficiently slow the economy down and reduce the inflationary pressures that materialized in the aftermath of a post-pandemic spending boom fueled by pent-up demand, monetary and fiscal stimulus and high savings levels. The challenge, however, is that the impact of higher interest rates is felt over time, fueling concerns that the Fed might raise interest rates too much or "overshoot" and continue doing so as the pace of the economy loses momentum.

A Revised Forecast

With that sentiment top of mind, the bigger development yesterday came within the Fed's updated Summary of Economic Projections (SEP). Here, the FOMC made significant changes to its interest rate forecasts for the coming years.

For context, this time last year, the Fed projected interest rates would be near zero in 2022 and gradually rise to around 2% by 2024. Their updated forecast now envisions interest rates moving close to 4.5% in 2022, moving slightly higher in 2023, then modestly falling in 2024. Both the level of interest rates and the length of time that interest rates would remain at that level was higher and longer than expectations.

Is a Hard Landing Inevitable?

Moreover, the upward revisions in the Fed's interest rates projections were accompanied by upward revisions to unemployment and downward revisions to economic growth. In short, the Fed's updated projections paint a hard-landing scenario suggesting the FOMC is willing to risk a recession in order to bring inflation down. The Fed certainly does not want a recession, but persistent inflation may have left the Fed no choice but to raise interest rates high enough to trigger one.

Indirectly, the Fed has indicated that the job market will be an unfortunate casualty in its battle against inflation, for, in their mind, a decline in job openings (which still approximate 11 million) will precipitate a decline in wages and will ultimately result in lower inflation. The pathway to accomplish that result starts with higher interest rates, which will inevitably affect businesses' desire to hire. The reduced demand for labor will finally reduce inflation.

Does the Fed Want to Cause a Recession?

For much of the last year, both policymakers and investors have underestimated inflation, and ahead of yesterday's FOMC meeting, some felt the Fed would be lowering interest rates in early 2023 although we were not in this camp.[1] Following yesterday's updated SEP, investors' expectations shifted, although not as much as the Fed's projections, despite a reiteration of the Fed's "restrictive for longer" mantra.

Thus, investor expectations may still be overly optimistic, especially considering that the Fed has raised the Federal Funds rate above inflation in every rate hiking cycle over the last 60 years, possibly causing further upward pressure on bond yields.

Our Outlook

Looking ahead, the key thing to watch, in our view, is the health of the labor market for it will likely validate or invalidate the Fed's approach to tackling inflation. Based on their projections, the Fed assumes higher interest rates will result in higher unemployment, a relationship that has repeatedly played out time and time again, and the level at which the Fed expects unemployment to rise has always been accompanied by a recession.

That said, today's labor market is uniquely strong relative to any other period. Moreover, the lingering economic effects of the pandemic make forecasting an extremely challenging endeavor. For these reasons, we advise investors to maintain a Neutral weighting to equities relative to their strategic asset allocation targets.

Volatility will almost assuredly persist, and additional downside may arise should the outlook for corporate earnings materially weaken. This leads us to recommend maintaining slightly higher-than-usual cash balances. Still, stocks are a preferred asset class for overcoming the harmful effects inflation can cause over the long run, and while bonds are becoming increasingly attractive, some less correlated strategies may serve as more effective diversifiers in these uncertain times.

In sum, yesterday, the Fed reiterated its stance that inflation is still a problem and they "must keep at it until the job is done." Interest rates, therefore, are poised to rise and the risks of a recession have risen accordingly. Investors would do well to also "keep at it" and make sure their portfolio is truly diversified and properly aligned with their long-term goals and aspirations.

For more information, please contact your advisor.

About the Authors

Cynthia is a Senior Portfolio Manager and is responsible for the performance of fixed income indexed investment portfolios including a broad range of custody, escrow, master trust and pension relationships; corporate, Taft-Hartley and public pension funds; endowments and foundations; corporate cash management and securities lending accounts.

Additionally, she is jointly responsible for fixed income investments of several KeyBank common and collective investment trusts and structured cash portfolios. Cynthia holds a Bachelor of Science in Finance from Cleveland State University and an MBA from Baldwin Wallace College.

As Chief Investment Officer, George Mateyo is responsible for establishing sound investment strategies for private and institutional clients, expanding internal and external research capabilities, and managing the delivery of solid risk-adjusted investment performance.

In previous roles, George spent more than 15 years in investment management and investment consulting, where he acquired firsthand knowledge and insights into the capital markets and the stewardship of investment portfolios for institutional and high net-worth investors.

George received his MBA from the Weatherhead School of Management at Case Western Reserve University and completed additional studies at the London School of Economics.

1https://www.key.com/kpb/our-insights/articles/stock-rally-breakout-or-fake-out.html

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