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COMMENTARY

August 29, 2022

Tough Fed Talk Will Continue to Rattle Markets

- S&P 500, Dow and Nasdaq drop more than 3% on Friday.
- Jerome Powell's Jackson Hole speech gave us few new insights.
- Fed may be talking tough to tame investor psychology.

Jerome Powell, the U.S. Federal Reserve Chair, managed to sink stock markets in a matter of about eight minutes. That is how long his speech was before markets reacted adversely. Stock markets had been trending higher over the past few months on hopes the Fed would be less aggressive, taking a "dovish pivot," as inflation may have peaked. Hopes were that the Fed would raise rates in September by 0.50% - 0.75% and then one smaller hike later in the year and pause. Was this wishful thinking?

Let us take a closer look at the transcript from this speech. Powell opened by reiterating the Fed's 2% inflation target and the importance of price stability. While concerned about labor inflation, the committee is confident that overall inflation is moving down, although still above the 2% target. The heart of the speech then centers around the three lessons learned from the 1970s and 1980s. First, is that central banks can and should take responsibility for delivering low and stable inflation. Second, is that the public's expectations about future inflation can play an important role in setting the path of inflation over time. Third, the Fed "must keep at it until the job is done."

Investors may have interpretated the speech to mean that the Fed is not pivoting to be more dovish. Thus, the Fed is willing to kill inflation at the expense of economic growth and employment. To take an analogy from the field of medicine, the Fed is willing to take the prescribed doses of antibiotics, regardless of the side effects, to destroy the bacteria for good. However, the Fed seemed to have already abandoned this idea of a so-called soft landing, where it could tame inflation and limit the negative side effects.

Nothing in this speech told us anything had changed. The Fed's outlook for inflation and its subsequent interest rate hikes did not seem to change. Did the Fed's resolve and commitment to tame inflation change? Not really, as the Fed seems equally committed to tame inflation as before. And frankly, this is a good thing. The Fed is already late to responding to inflation after considering it transitory or temporary for too long.

Dissecting the speech, the key insight may be in his second point around expectations. In the 1970s and 1980s, inflation had a psychological component to it. If you think inflation is going to rise, you will buy more goods and services now before it goes up in price. This psychology only perpetuates more inflation. It is a self-fulling prophecy. To kill inflation, the Fed may need to kill inflation expectations. Perhaps that is why they also recently got rid of their forward guidance, which showed they were more dovish in the future. A perceived hawkish Fed can help tame inflation.

So, while inflation data could continue to weaken, we expect Fed officials to continue to talk tough. We will continue to focus on the data and especially labor data as labor inflation tends to be more persistent. Ultimately, the data will drive the Fed's decisions going forward. This week we get key data points in home prices, consumer confidence, and employment data, including wage data. Market volatility will be elevated as investors digest Fed comments and new data. In this environment, please continue to work with your financial professional to make sure you are properly diversified to help mitigate market volatility and your portfolio is aligned with your long-term investment objectives.

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