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## Thoughts from the CIO: Has the Federal Reserve Panicked?

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*Panic - Sudden uncontrollable fear or anxiety, often causing wildly unthinking behavior.*

*Panicked - Thrown into a state of intense fear or desperation*

-Merriam-Webster Dictionary

*Elevated inflation may take years, not months, to bring down to the targeted level.*

As we begin a new quarter, chaos is building in the capital markets with the fixed income markets hit particularly hard. The Fed waited too long to lift rates to counteract the worst inflation in decades and now must contend with the impact of their tardiness. Lifting interest rates is the right thing to be doing, but

is the desperate pace we're seeing necessary and beneficial? We think not.

Elevated inflation may take years, not months, to bring down to the targeted level. While raising short-term rates and shrinking the Fed's balance sheet of long-term bonds is prudent, the frenzied pace of these changes is now making the "hard landing" a virtual certainty.

Residential mortgage rates are approaching 7%<sup>1</sup> and, with present policy, may be headed to 8% or higher. Slowing the housing market down makes sense. Engineering a major housing downturn does not. If 6% mortgage rates are enough to cool off housing, what is the benefit of seeing rates move much higher?

What should the Fed be doing? After massive intervention by the Fed in the long treasury and mortgage markets, withdrawal from this activity, or so called "quantitative tightening", should proceed at a deliberate and not urgent pace. After each incremental move drawing down the Fed's balance sheet, the economic effects should be evaluated before proceeding further. Much has been made of yield curve "inversions" being predictors of recession. We would argue the opposite: long rates much higher than current short rates create a greater risk of recession.

In the past, inverted yield curves have occurred with positive real rates on long maturities and very high real rates on short maturities. This makes borrowing very costly and creates disincentive for financial intermediaries to lend. This time, both short and long-term real yields on treasuries are negative. With Fed Funds expected to exceed 4%, a positively sloping treasury curve could hurt housing more than a modestly inverted curve would likely impact lending.

Also, the pace of Fed Funds hikes can be moderated. What does it really matter if reaching a targeted rate occurs a few months later? Slowing this down gives the economy and markets a chance to adjust to the changes, and gives policy makers a chance to evaluate the impact before making the next move. Signs are already emerging that inflation will be coming down.

The global marketplace has also become increasingly unpredictable with spiking market volatility. Volatility most likely will continue to be heightened, requiring the Fed to respond in a judicious fashion. Let's have policy that is prudent, rational and not panicked.

<sup>1</sup> Source: Bankrate.com, National Average Mortgage Rate - 30-year fixed, data as of 9/30/2022.

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