THE FED'S RATE HIKE, AND IMPLICATIONS FOR INVESTORS

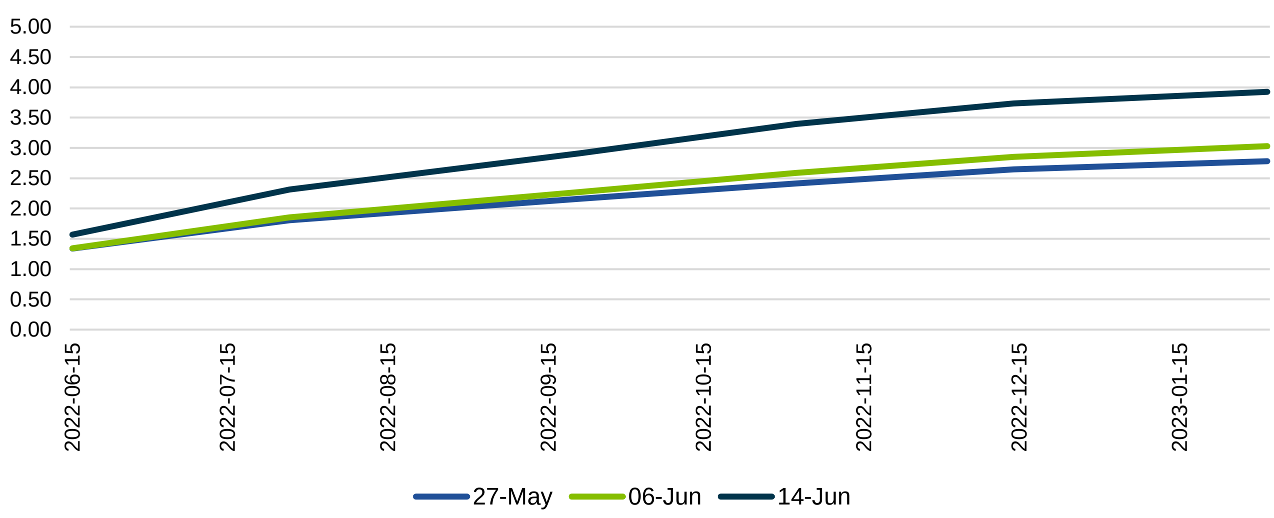
NEI

At its June 14–15 meeting, the U.S. Federal Reserve increased the Federal Funds rate by 75 basis points to 1.50%–1.75%. The inflation projection by the Fed has been revised upward for 2022, while the economic growth projections for 2022, 2023, and 2024 have been revised downward. This decision confirmed that the Fed is willing to tackle inflation, even at the expense of potentially higher unemployment rates and slower economic growth. In his press conference, Fed Chairman Jerome Powell noted that "it does appear that the U.S. economy is in a strong position, and well positioned to deal with higher interest rates."

Upside surprise in inflation in May triggered aggressive tightening

- On June 11, the U.S. Consumer Price Index (CPI) came in at 8.6%, up from 8.3% the previous month. This is a 40-year high for U.S. inflation, with notable price increases in gas, oil, and food.
- The market reacted by sending Fed Funds Future rates higher. The futures market priced in 75-bp hikes for both June and July and increased expectations that the Fed policy rate would be 4% by early 2023, an expectation that was only at 3% as recently as few weeks ago.

Fed Futures implied rates



Source: Bloomberg, as of June 15, 2022.

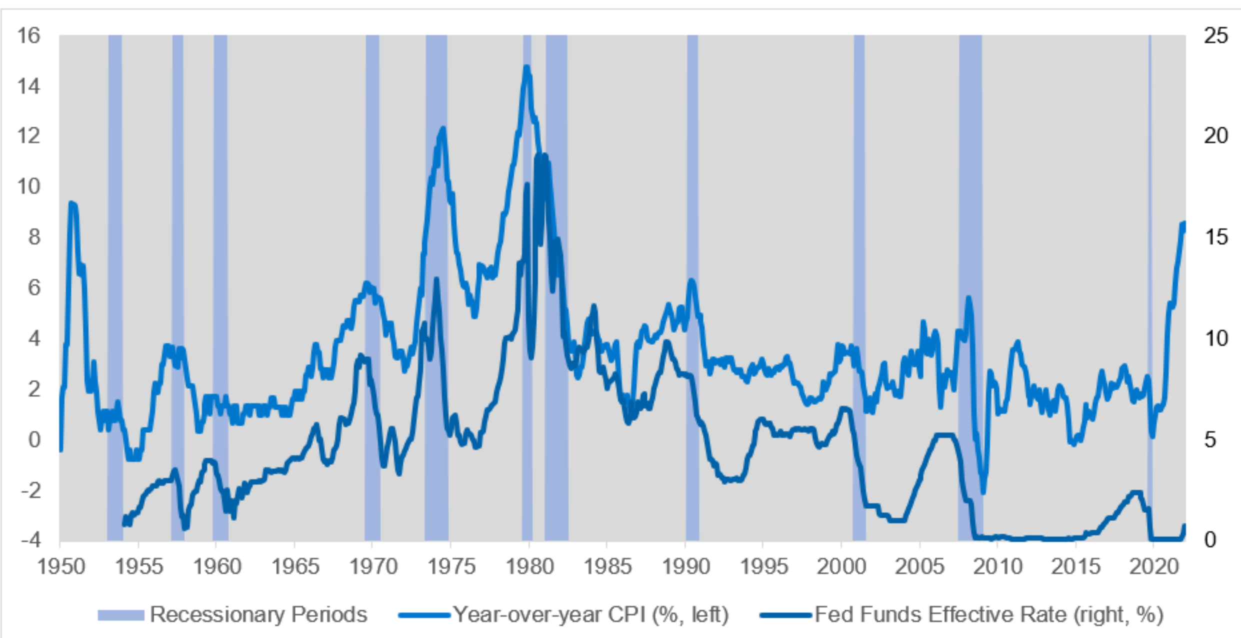
- Policy rate expectations are important because the so-called neutral rate, the level of interest rates that are neither stimulative nor restrictive to economic growth, is widely seen as between 2%–3%. At 4%, the Fed policy rate would be in restrictive territory.

- As a result, economic growth projections for 2022 and 2023 were moved lower from 2.8% in 2022 and 2.2% in 2023, to 1.7% for each year. This is below the long-term economic growth rate of 1.8%–2.0%.
- The Fed's dot plot, a chart that records each Fed official's projection for the central bank's key policy rates, has moved upwards considerably, consistent with the market's view. This implies that the central bank is moving more aggressively to rein in inflation. The intention is to increase borrowing costs to dampen aggregate demand, in order to moderate the supply and demand imbalance which is the main driver of high inflation.
- The broad-based equity market drawdown over the last few months was mainly a result of investors downgrading their expectations of economic growth while factoring in a higher rate environment, resulting in lower valuations despite stable corporate earnings. In fixed income markets, bond prices dropped and yields rallied in expectation of interest rate hikes, and spreads widened as financial conditions tightened.

Investor impact and NEI's outlook

- Historically speaking, high inflation combined with Fed tightening have often resulted in recessions. Since May's strong inflation reading, parts of the yield curve have started to invert, suggesting further tightening of financial conditions.

High CPI, high rates historically result in recessions



Source: Bloomberg, as of May 31, 2022.

- Given persistently high oil prices and rising rates, the risk of recession has risen, indicated by weakening consumer sentiment stemming from spending being deferred due to financial pressures from gas prices, among other factors. The resulting demand destruction from consumers will ultimately dampen inflationary pressures, which in turn alleviates the need for the Fed to continue to aggressively hike rates.

- Despite increased chances of recession, a recession in 2022 is not the base-case scenario for NEI. We expect inflation to moderate later this year as China emerges from its lockdowns, easing supply chain disruptions. Furthermore, household balance sheets are not overly stretched, corporate earnings growth remains strong—with the expectation to deliver over 5% growth by the end of 2022—and business investment remains robust.
- At the portfolio level, NEI has adopted a neutral positioning, acknowledging the elevated inflation and recession risks as bearish signals, balanced with corporate fundamentals that remain robust and household balance sheets that are still not overly stretched.
- We are closely watching for pressure on corporate profit margins as input costs and wages are expected to continue to rise, and for the housing market to continue to soften as mortgage rates have risen dramatically.
- The market is broadly devaluing companies to reflect a slower growth and higher rate environment. In this environment, our managers who focus on companies with strong balance sheets and high cash flow generation should be able to recover faster than the broader market.

The actions of central banks such as the Fed will continue to figure prominently in the news for a long time as inflation pressures, geopolitical events, and changing economic conditions potentially create uncertainty for investors. At NEI Investments, we're committed to providing you with our insights to help you put current events into context for your clients.

If you have any questions about NEI's solutions or other ways we can help you with your client engagements, please contact your NEI sales representative.