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Daily Observations

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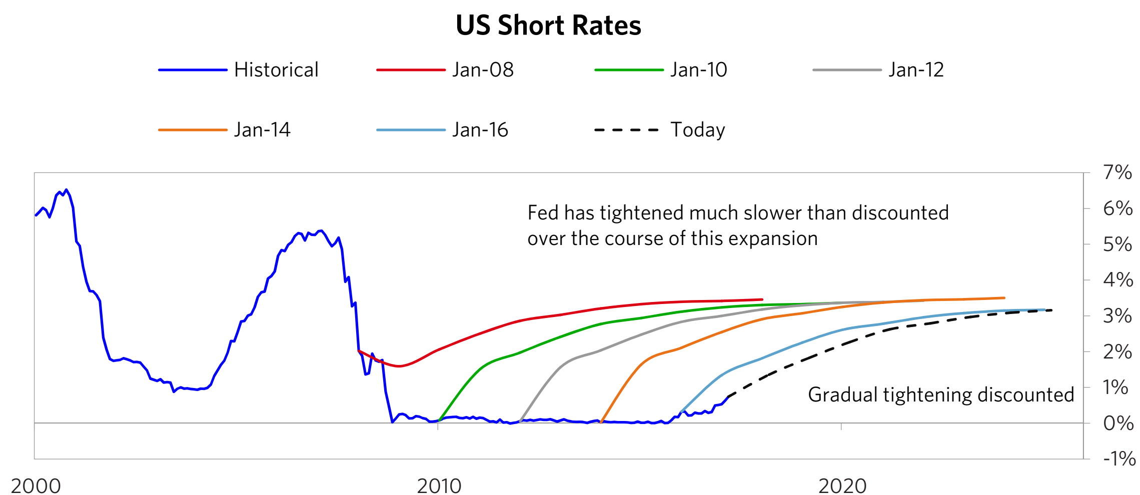
Perspective on the Current Fed Tightening Cycle

As we see it, the US economy is now in something like the seventh inning of the expansion—it is in the later stages of the business cycle, but not quite near the end. Growth is solid, the economy is now operating somewhat above capacity, and inflation is rising gradually, consistent with where we are in the cycle. That said, inflation remains low and, as far as monetary policy is concerned, the economy is still on a good trajectory. We think years like 1977 or 1988, when the Fed was just beginning to normalize policy, are somewhat analogous from a cyclical perspective. These can be calmer transitional years, before a sharper rise in inflation leads to a more material tightening. Asset prices can continue to rise during this phase of the cycle, supported by plentiful liquidity, though the upside is more limited than earlier in the expansion because asset prices are no longer cheap.

Of course, there are important differences about the current environment. Politics are more likely than usual to impact markets. This expansion is also playing out within the context of a deleveraging, where debt levels are high, and the ability of central banks to ease next time the economy experiences a downturn is much more limited. This creates material risks for the economy and asset prices. The Fed (and other central bankers), recognizing that risks are asymmetric, is tightening gradually. Looking ahead, rising rates will continue to not be problematic if they do not rise faster than what is discounted, and, as a result, we don't think that Fed policy will be as important a driver of the economy and markets as is typical for quite some time.

In these *Observations,* we provide some perspective on US cyclical conditions relative to prior tightening cycles. The first chart below shows how consistently slower the Fed has moved relative to what had been discounted. After meaningful progress in the economy, the current path of market discounting largely makes sense to us.



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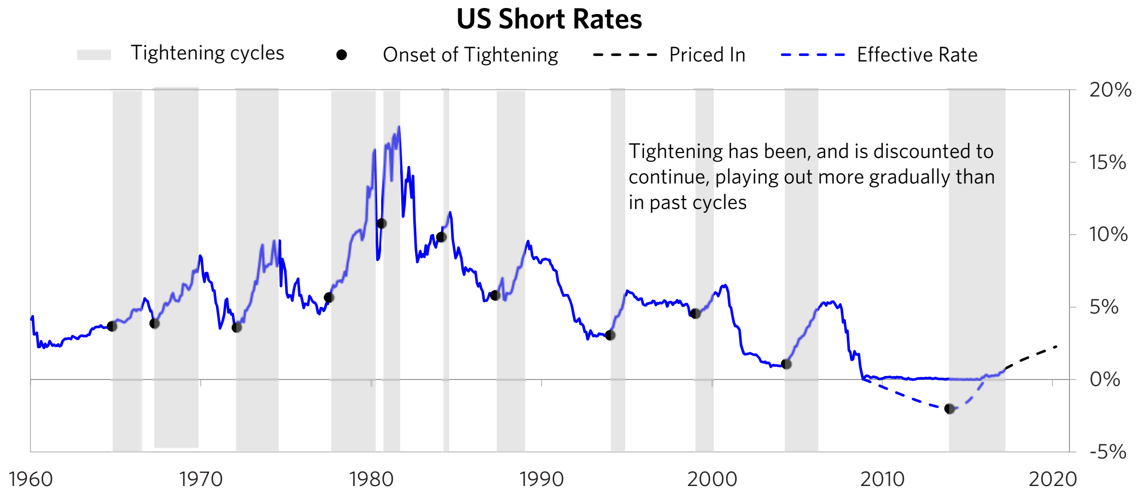
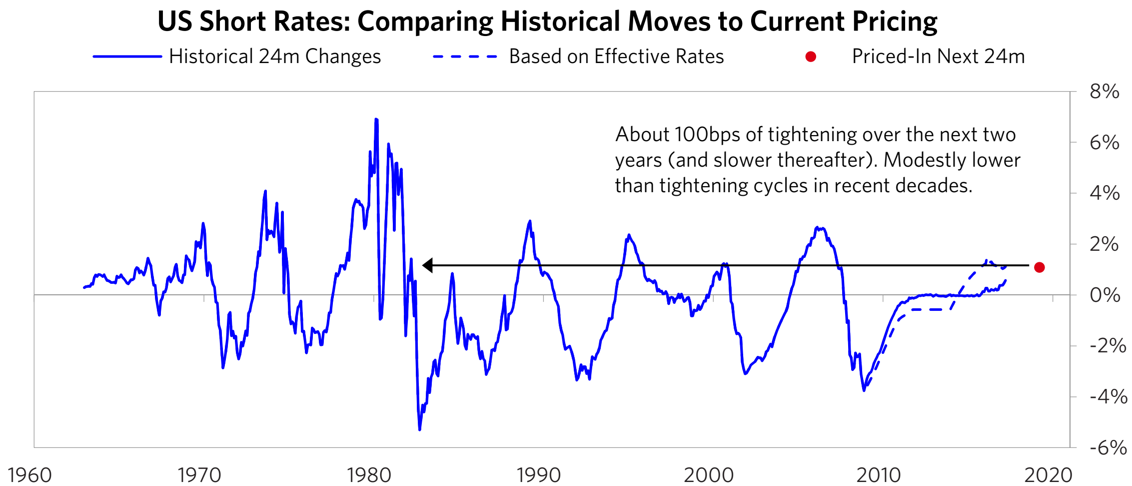
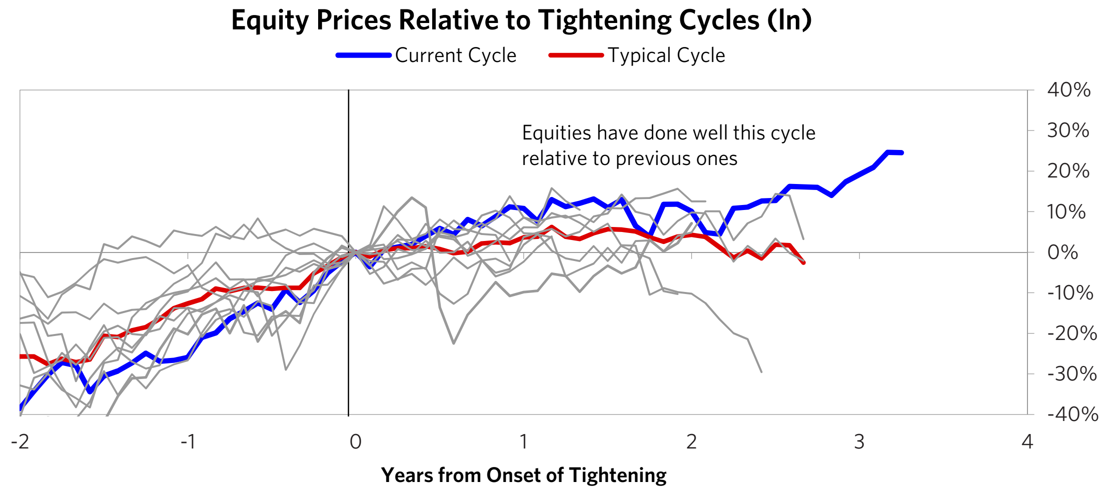
Below, we put the current tightening cycle in perspective. This tightening cycle has played out in slow motion, with the Fed erring on the side of tightening later and more gradually than before. Including the original tightening of the roll-off of QE, this is now the longest tightening cycle in terms of elapsed time in the US in decades and is discounted to continue for years. Nominal short rates are priced in to peak at only around 3%, in part due to high levels of indebtedness. As long as the Fed doesn't tighten faster than discounted, the impact of the Fed on markets will be more muted than in past cycles.



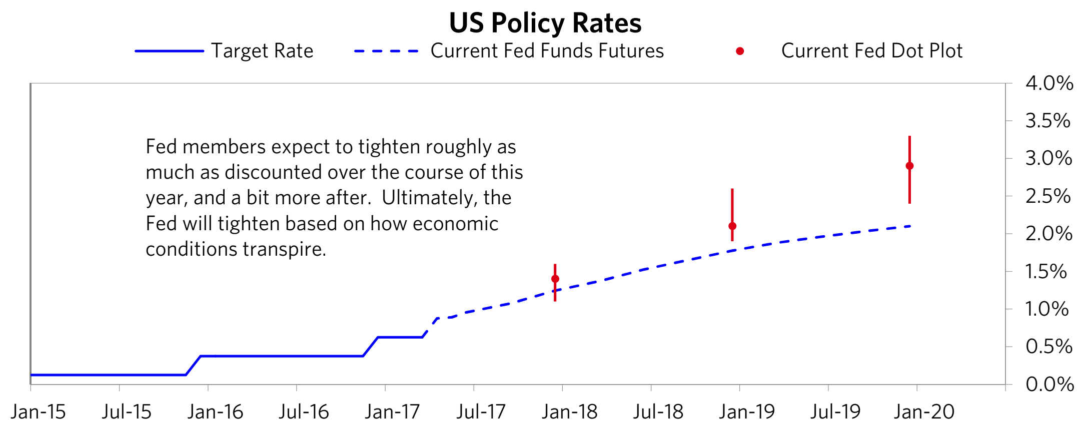
The chart below shows historical changes in rates to put the current pricing into context. The Fed tightening cycle began with the pullback of QE, and once we incorporate that tightening (see dotted line below) the Fed has been raising rates by about 50bps a year this cycle. Looking beyond the expected tightening later today, which is fully discounted, markets are discounting the Fed to tighten an additional 100bps over the next two years, and then go very slowly after that. This pace of tightening for the next two years is modestly less aggressive than the peak tightening pace of recent expansions, and is then discounted to slow thereafter.



In terms of the impact on markets, a key driver of asset performance is how quickly the Fed moves relative to what is discounted. The Fed's cautious approach this cycle has been supportive of asset prices. This has been one of the stronger equity markets since the onset of tightening.



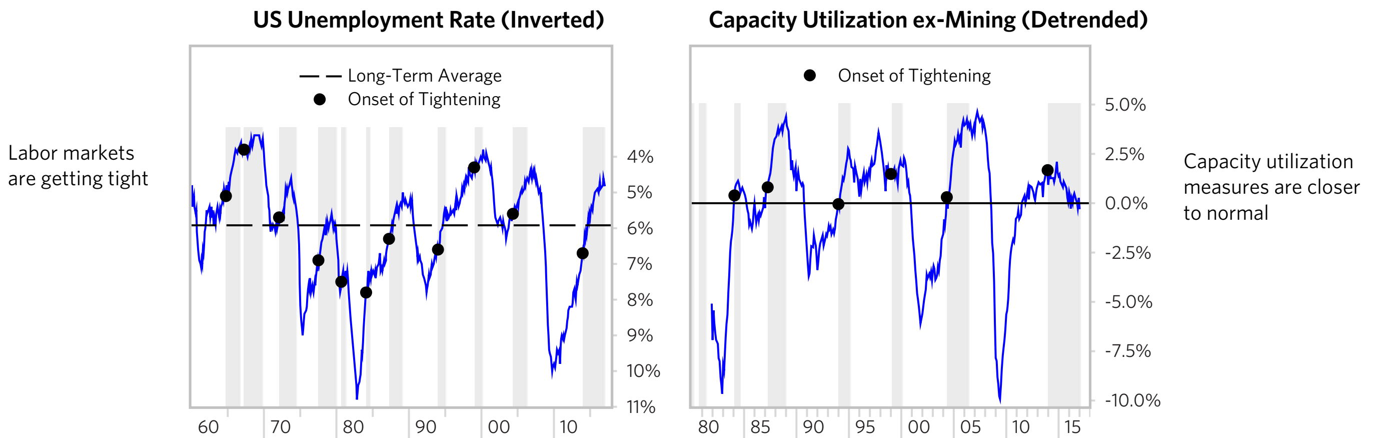
The Fed's own thoughts on rates are in line with markets for the next year, with expectations being a bit more hawkish beyond. The Fed is clear that these expectations are meant to be only a very rough guide of their thinking and that ultimately their actions will be based on how conditions transpire. They have also acknowledged that their own expectations for tightening earlier in the expansion were too aggressive. Because of the asymmetrical nature of the risks, the Fed is not attempting to get ahead of inflation. The Fed is likely to continue to accommodate the expansion, tapping on the breaks only slightly as long as inflation remains under control.



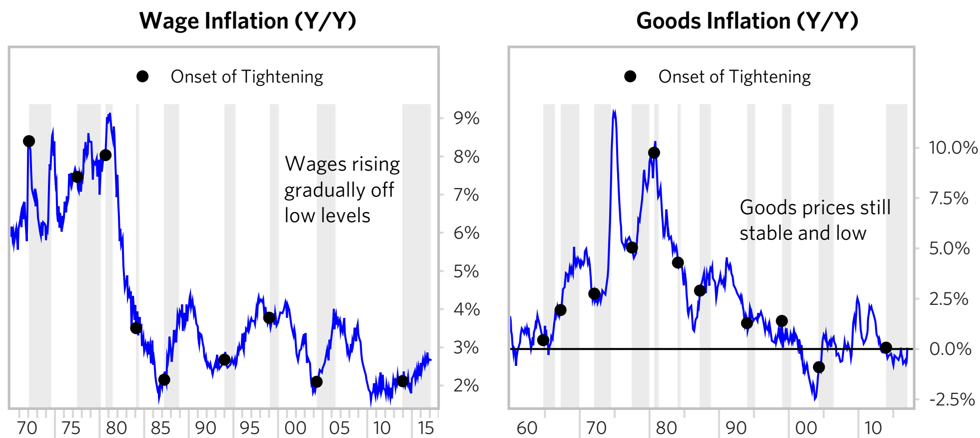
Below, we show how current conditions compare to past expansions.

Economic Conditions Are at a Point Where the Fed Would Typically Be Tightening More

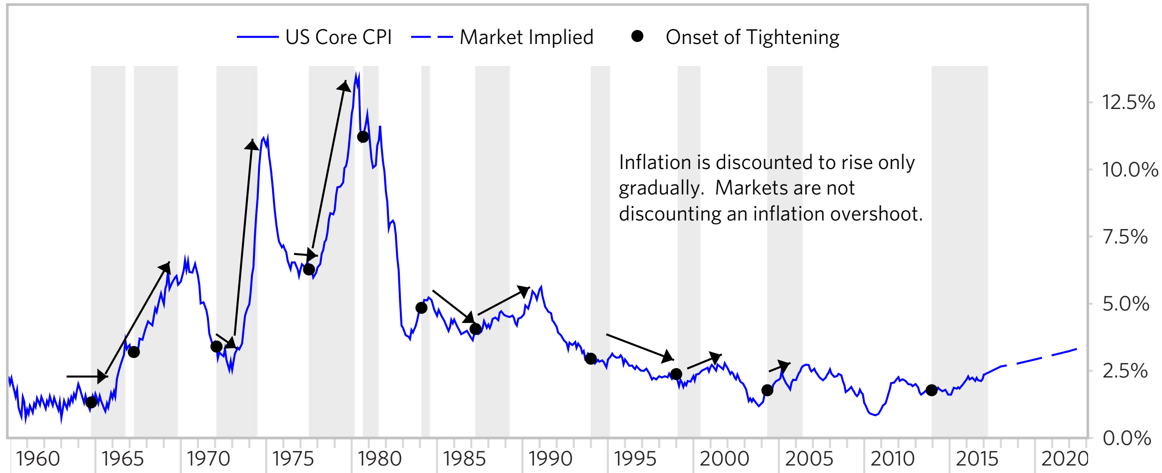
It has taken many years of moderate growth to get the US economy to recover cyclically from the contraction following the financial crisis, but at this point levels of activity are no longer depressed. As we have discussed in detail in prior *Observations*, labor markets are now getting tight, with the unemployment rate overstating only slightly the degree of recovery. Other measures of economic activity, such as capacity utilization, aren't quite as strong but are also consistent with an economy that has fully recovered. Growth rates above potential are likely to continue to gradually put upward pressure on inflation, creating more of a need to tighten than earlier in the expansion. These pressures, however, continue to be gradual for now.



In terms of inflation pressures, they are most clear in labor markets where wage pressures are gradually emerging. Wage growth is still mediocre, but it is rising. Meanwhile, goods prices are much weaker. The combination of less strong cyclical conditions globally (growth is stronger now, but levels of activity are weaker than in the US) and the strong dollar is keeping goods price inflation down. It remains to be seen how policy shifts under the new administration may change these pressures, but they are increasingly likely to play out gradually as well.



The Fed typically starts tightening monetary policy before inflation starts to rise materially. Early in the tightening cycle, they tap on the brakes, not pushing toward more aggressive tightening until inflation becomes a bigger concern. Inflation is rising off low levels, but only slowly. Market pricing is for a continued and very gradual rise in inflation. The current trajectory of inflation is consistent with the Fed continuing to accommodate the expansion.



Lastly, the US economy is on the back end of the long-term debt cycle, and still-high debt levels mean that the economy is more sensitive to interest rate increases. The low level of rates at this point means that debt service costs are near 40-year lows, so there is clearly some ability to raise rates. Nonetheless, rates are currently discounted to peak at levels well below what they had been prior to the financial crisis, implying that the increase in debt service costs will be contained. We walk through where the US is in its deleveraging in the section below.