COLUMBIA THREADNEEDLE INVESTMENTS

The Fed on inflation: Doing whatever it takes

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Earlier this year, we outlined two possible scenarios for monetary policy. With its most recent action, the Fed has clearly landed on one side.

With a 75 basis point rate hike at its June 15 meeting, the Fed intended to send a very clear message to markets: It is serious about bringing inflation down. In doing so, the Fed is executing on the aggressive tightening scenario we laid out earlier this year. But when we presented these scenarios, the aggressive path was not our likely outcome. So, what changed? Persistent high inflation that didn't dissipate as expected. Instead, it continued to surprise on the upside, largely blindsiding the Fed.

In the aggressive tightening scenario, we think the Fed will frontload interest rate increases — aiming for a higher terminal rate of 3.5%-4.0% in 2023 —fostering tighter, even restrictive, financial conditions. This reflects an explicit recognition that it will take decisive action to ensure that elevated inflation does not fuel higher inflation expectations and does not become embedded in the economy.

The Fed's forecasts signal that it is expecting its actions to lower growth and increase unemployment. The tightening of financial conditions — including by reducing its balance sheet — should pressure corporate and consumer balance sheets, and eventually the labor market. From the Fed's perspective, the risk of higher inflation (and consumers expecting higher inflation) outweighs the risk of slower growth and higher unemployment. A soft landing is still possible, but regardless, it will be a bumpy ride. And investors should be prepared for more risk and continued uncertainty ahead.

To date, the sell-off that we have seen in fixed-income markets has been characterized as a rate sell-off. With tighter financial conditions, could that translate to a credit sell-off as well? Maybe, but corporate balance sheets still are generally strong in our view. That said, paying attention to which issuers may be at risk and being active through rigorous credit research is taking on increasing importance as the year progresses.

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