PACIFIC FUNDS insights

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HIKING INTO UNCHARTED TERRITORY

The Federal Reserve raised rates by 0.75% for a third consecutive time, as the Fed continues to try to curb inflation.

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Key Takeaways

- As expected, the Federal Open Market Committee (FOMC) increased the federal funds target rate range to 3.00%–3.25%, a 0.75% increase.
- Median projections from the committee members showed two more potential hikes by the Fed through the holiday season, with one hike being at least 0.75% or greater. Next year's projections showed just one potential 25 bps hike. As for potential rate cuts, there were three projected in 2024 and four in 2025.
- The Fed's economic outlook showed a material change in GDP, while inflation saw a marginal increase. The committee's GDP estimates moved lower from 1.7% to 0.2%, while the core PCE price index increased from 4.3% to 4.5%.

At their September meeting, Federal Open Market Committee (FOMC) members agreed to hike the fed funds rate by 0.75% for a third consecutive time, raising their benchmark rate to a range of 3.00%–3.25%. Market expectations started the week with an 82% probability of a third 75 bps hike at the sixth Fed meeting of the year. In the week leading up to the meeting, the probability of a 100 bps hike in the Fed's benchmark rate rebounded slightly with some expectations for a 1.00% increase.

This week's rate hike further highlighted the committee's plans to do what is necessary to tame inflation. In August of this year, Chair Jerome Powell made it clear the FOMC was singularly focused on bringing inflation back to 2% and that this may require some economic pain, likely in the form of sustained below-trend growth and a softening of labor market conditions. This third 75 bps hike has put the fed funds rate into a range that most participants would consider as broadly neutral, albeit still falling short of the "moderately restrictive" rate stances that the FOMC is looking to implement at the culmination of its hiking cycle.

As for the economy, the Fed lowered estimates for GDP growth in 2022 from 1.7% to 0.2%, which now sits well below the committee's long-term estimates. The Fed raised inflation estimates from 4.3% to 4.5%, as the current actions taken by the committee have yet to calm inflationary pressures. Unemployment projections increased from 3.7% to 3.8%, with projections for unemployment hitting 4.4% in 2024, as price pressures and slower economic growth are expected to continue to weigh on labor market conditions over the next few years.

Below are the language changes made in the Fed's statement from July:

July 27, 2022 Statement	September 21, 2022 Statement
Recent indicators of spending and production have softened. Nonetheless, job gains have been robust in recent months.	Recent indicators point to modest growth in spending and production. Job gains have been robust in recent months.

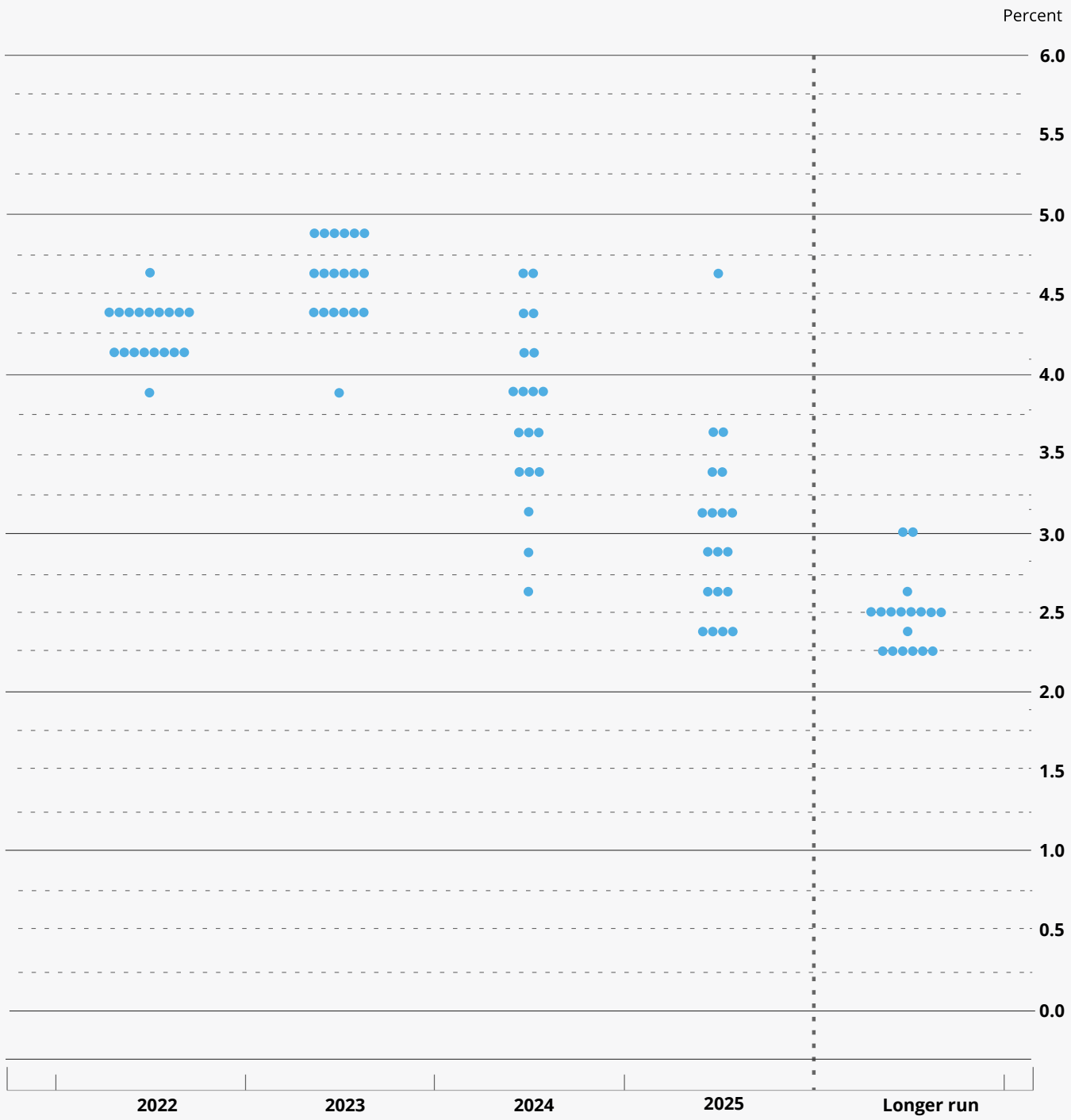
Source: FOMC as of 9/21/22.

Here are the committee's September projections for GDP, unemployment, inflation, and the federal funds rate for 2022 through 2025:

	Median Projections				
	2022	2023	2024	2025	Longer Run
Change in real GDP	**0.2%**	**1.2%**	**1.7%**	**1.8%**	**1.8%**
June 2022	*1.7%*	*1.7%*	*1.9%*	-	*1.8%*
Unemployment Rate	**3.8%**	**4.4%**	**4.4%**	**4.3%**	**4.0%**
June 2022	*3.7%*	*3.9%*	*4.1%*	-	*4.0%*
Federal Funds Rate	**4.4%**	**4.6%**	**3.9%**	**2.9%**	**2.5%**
June 2022	*3.4%*	*3.8%*	*3.4%*	-	*2.5%*
Core PCE Inflation	**4.5%**	**3.1%**	**2.3%**	**2.1%**	-
June 2022	*4.3%*	*2.7%*	*2.3%*	-	-

Source: FOMC as of 9/21/22.

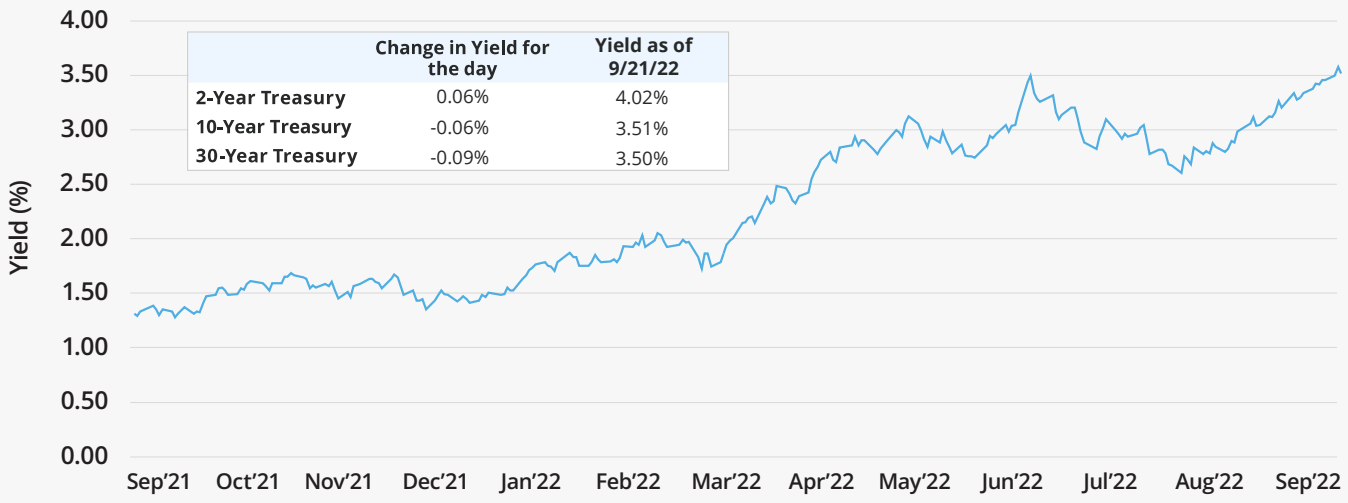
The committee's "Dot Plot" showed noticeable changes in the projections for the fed funds rate in 2022, 2023 and 2024, and gave markets a first look at 2025 projections. The chart showed 17 of 19 committee members expecting the fed funds rate to finish 2022 above 4%, with 10 of 19 members seeing the benchmark rate above 4.25%. For 2023, most committee members expect the benchmark rate to be above 4.5%, implying that markets should expect at least one potential hike in the year. As for rate cuts, the committee does not see rate cuts happening until 2024, as projections showed three potential 25 bps decreases in 2024 followed by four potential cuts in 2025.



Source: FOMC as of 9/21/22.

After the Fed announcement, the 10-year Treasury ended the day lower by six bps to 3.52%; short and long rates were mixed with the 10-year/ 2-year Treasury spread touching year-to-date highs.

10 Yr Treasury Yield over the last 12-months



	Change in Yield for the day	Yield as of 9/21/22
2-Year Treasury	0.06%	4.02%
10-Year Treasury	-0.06%	3.51%
30-Year Treasury	-0.09%	3.50%

Source: : FRED as of 9/21/22. U.S. Department of The Treasury as of 9/21/22.

In Conclusion

Markets closed in negative territory on the final day of the FOMC meeting. Both the Dow Jones Industrial Average and S&P 500 Index moved lower during Chair Powell's press conference. The Dow and S&P 500 finished the day down at -1.70% and -1.71%, respectively. As the committee continued to rein in inflation more aggressively, Treasury yields on the long end moved lower while front-end rates moved up. The 10-year and 2-year treasury spread touched a year-to-date low of -0.51% following the release of the Fed's statement, a level that investors haven't seen since April 2000.

Investors were prepared for the Fed to continue down their path and Chair Powell maintained his hawkish tone from past meetings, as the committee delivered on expectations with a 75 bps hike in the benchmark rate. Chair Powell said the impact of monetary policy will have "long and variable lags," with immediate impact on financial conditions and a flow through to economic activity. Inflation, the intended target of these hikes, can take more time to feel the full impact of Fed actions, but Chair Powell mentioned that we have likely moved into the "lowest level of restrictive with a ways to go." The committee's projections showed a revision to the unemployment rate to 4.4% in 2023, which may be seen as the Fed hiking the economy into an actual recession. Chair Powell addressed this concern by describing the current situation as, "outside of historical experiences in many ways" and mentioned that it is quite plausible that the Fed's actions have the intended impact of the committee given the series of supply shocks, the Russia/Ukraine conflict and record job openings combined with low unemployment. It was made clear by the committee that they stand by their decision to continue to hike interest rates in light of potential economic pains. We believe there were some positive signs that we may see an end to this hiking cycle in the coming year, as commodity prices appear to have peaked and supply chain constraints seem to have begun to ease.

Definitions:

One **basis point** is equal to 0.01%.

The **Dow Jones Industrial Average index (DJIA)** tracks the share price of the top 30 large, publicly-owned U.S. companies which is often used as an indicator of the overall condition of the U.S. stock market.

Gross Domestic Product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period.

Personal Consumption Expenditures (PCE) refers to a measure imputed household expenditures defined for a period of time.

The **S&P 500 index** is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the U.S. stock market.

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