The Fed admits the economy is slowing

Here's what that means

The **Federal Reserve** hiked rates 0.75% on Wednesday, which was mostly expected by market participants before the announcement. The question is, will the Fed keep aggressively hiking rates if the economic data worsens? I say this because I've raised all but one of my six recession red flags. I need to wait for one more report to officially raise the last flag, but it is certain to happen in August.

On the call following the Fed's announcement, people were eager to ask Fed Chair Powell about weakness in the economy, and Powell did admit that the economy got softer in the second quarter.

The Fed's dual mandate requires them to ensure we have price stability, and the inflation data is way too hot for them to ever think about not raising rates. Since we are still creating jobs in the economy, that gives them cover to keep hiking rates until they see inflation falling. However, the discussion today provided good clues into Powell's mindset, or at least how I viewed his talking points.

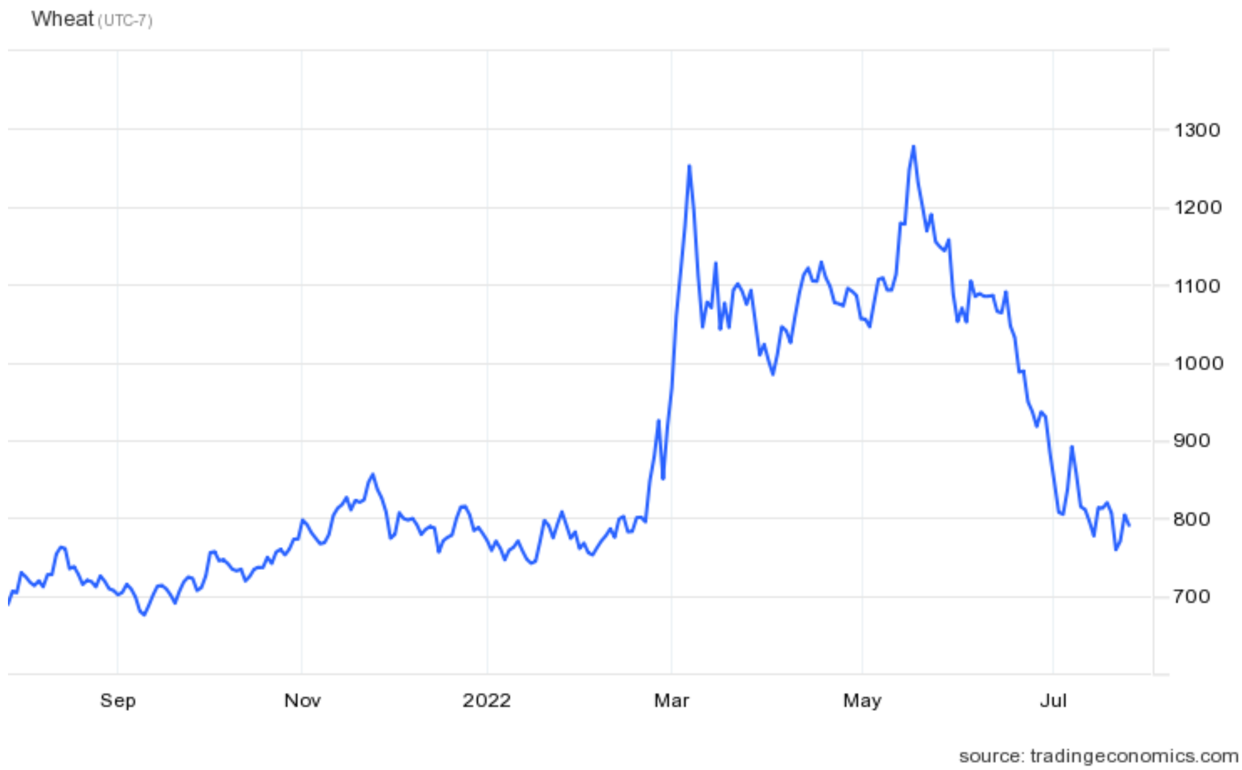
First, here is the official statement from the Fed:

Recent indicators of spending and production have softened. Nonetheless, job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher food and energy prices, and broader price pressures. Russia's war against Ukraine is causing tremendous human and economic hardship.The war and related events are creating additional upward *pressure on inflation and are weighing on global economic activity. The Committee is highly attentive to inflation risks.*

Breaking this down, Powell said consumer spending, housing, and fixed business spending has been softening. Going forward, Powell said the Fed wants to see "compelling evidence that inflation is moving down." To me, this is the biggest statement of the day, because it sounds like a man trying to blink.

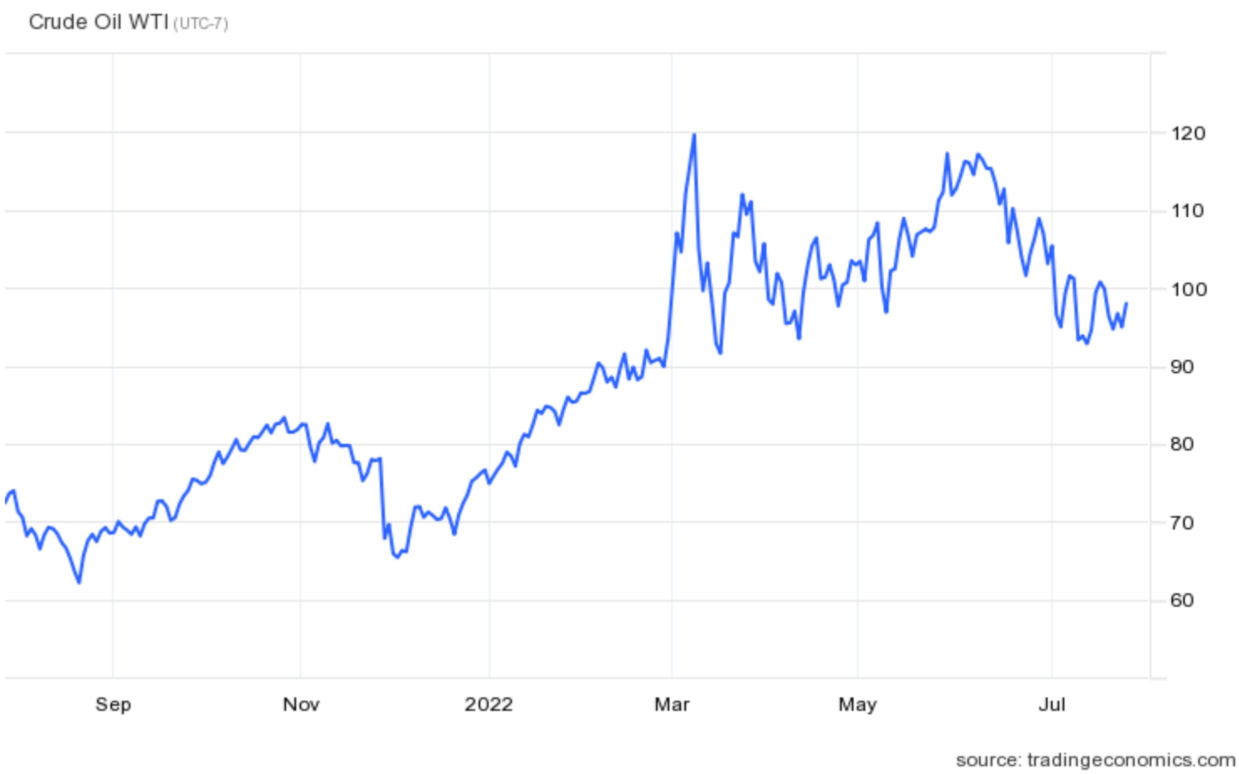
Powell also said the pace of those increases "will continue to depend on the incoming data and evolving outlook for the economy." My take on this — and also why the 10-year yield is lower from recent highs — is that the bond market knows that the economy is getting weaker while the Fed is hiking more and more. This means the Fed is hiking into recessionary data.

The Fed has always talked about how prices have gotten hotter due to the Russian invasion of Ukraine and some of that heat has fallen recently on some of the commodity prices, such as wheat prices. Now we can see that copper prices are falling more noticeably as well. Whenever copper prices fall aggressively, that isn't a good sign for the economy, especially for housing.



The Fed is trying to achieve price stability, but they don't really have the tools for some of the supply constraints. Higher mortgage rates have created more supply for the existing housing market. However, higher rates have also shut down construction for this expansion. This will continue until rates go back lower after the builders get rid of the backlog of homes they need to build out.

The price of oil is not really something the Fed controls here, because the U.S. dollar is already super strong. In the past, this would have impacted oil prices, but it's not the case anymore due to other factors such as the Russian invasion, as the Fed has noted.



We have seen commodity prices fall recently. But, we still have the X variable of the Russian invasion and possibly China creating more chaos with Taiwan. What if we get more aggressive commodity prices due to supply constraints: does the Fed keep hiking even though they know that they can't control this aspect of inflation?

Powell has admitted that hiking rates can't really bring oil prices down on their own. A simple way to look at this is that if the U.S. goes into a job loss recession, then fewer people are driving to work each day. That isn't a popular statement the Fed can make, so don't expect them to say this anytime soon.

Powell even talked about how the Fed wants to see a growth slowdown:

- "We think it's necessary to have growth slow down."
- "We think we need a period of growth below potential."
- "We think there will be, in all likelihood, some softening in the labor market."

Well, welcome to the party, pal, we are already there.

Watching Powell speak, I get a sense that the Fed is mindful of the slowdown, but the jobs data is giving them cover. If we were losing jobs, then I believe the narrative of Fed rate hikes would change.

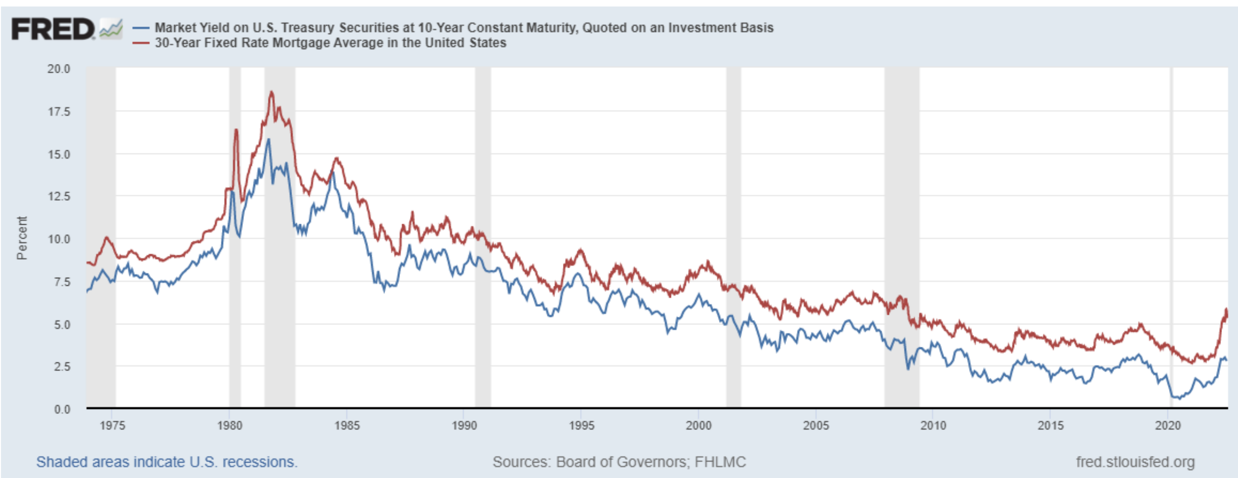
Powell kept talking about the slowdown in the second quarter and the leading economic index peaked in May of this year. With this context, the bond market is correct here. The 10-year yield is much lower than the recent peak of 3.50%, reflecting the reality that growth is slowing. and if it gets worse, the Fed will change its tune because they have admitted today that some of the second-quarter data is showing real weakness.

I don't believe Powell wants to openly say this because he is afraid of rates falling and stocks rising. We are going to enter the data-dependent dance from now on, and the tip-toeing talk about recession, expansion, and which one of their mandates is more important: jobs or inflation. For now, clearly, inflation is top priority.

So how does this Fed action affect mortgage rates?

Given the Fed's aggressive rate hikes, why have mortgage rates fallen from their recent peaks of more than 6%? As we all know, mortgage rate pricing got very stressed in recent months, rising a bit above the historical norm given their relationship with the 10-year yield. Some of this wild pricing is coming from a stressed marketplace, but in general, when the 10-year yield rises so do rates and vice versa.

The 10-year yield recently went as high as **3.50%** but on Wednesday went as low as **2.72%**, a noticeable reversal in bond yields.



Wednesday's reaction from the bond market wasn't surprising at all, even though some people believed that mortgage rates and bond yields would go up in a big fashion after the news. The bond market has been ahead of the Fed rate hikes and it looks to me that for now, the market is anticipating the Fed will be less aggressive in the future.