28 July 2022

Fed raises interest rates by 75 bps again to clamp down inflation

Key Highlights

- Fed **raised interest rates by 75 bps** - to lift their key rate to a **target range of 2.25% to 2.50%.**
- "As the stance of monetary policy tightens further, **it likely will become appropriate to slow the pace of increases** while we assess how our cumulative policy adjustments are affecting the economy and inflation," Fed Chairman Jerome Powell said.
- The Fed Chairman said that he **did not believe the economy was in recession**, citing a **"very strong labour market"** as evidence.
- He also added that they are **continuing with the process of significantly reducing the size of its balance sheet.**

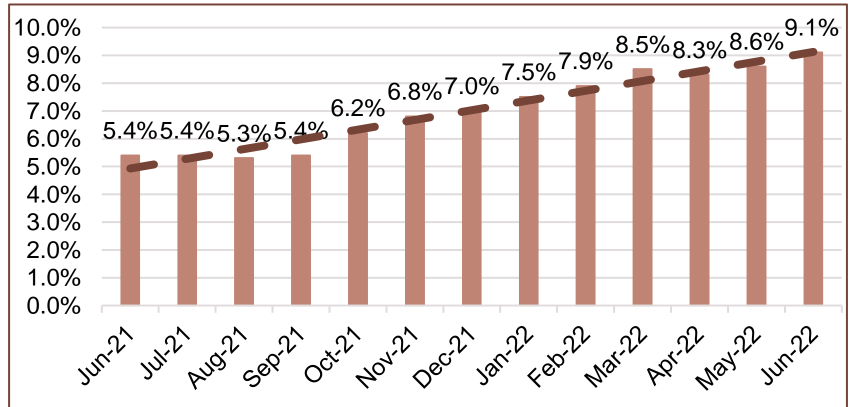
Key Highlights

- In line with expectation the Federal Reserve (Fed) on Wednesday once again **raised interest rates by 75 bps, taking the cumulative June-July increase to 150 basis points -- the steepest since the price-fighting era of Paul Volcker in the early 1980s,** unleashing the most aggressive policy action in decades to combat soaring inflation.
- The U.S. policy makers voted unanimously to lift their key rate to a **target range of 2.25% to 2.50%**, the fourth increase since 2018, after two years of holding borrowing costs near zero to insulate the economy from the pandemic.
- "As the stance of monetary policy tightens further, it **likely will become appropriate to slow the pace of increases** while we assess how our **cumulative policy adjustments are affecting the economy and inflation**," Fed Chairman Jerome Powell said. He also added "We think it is necessary to have **growth slow down**. Growth is going to be slowing down this year for a couple of reasons"
- The FOMC noted Wednesday that "recent indicators of **spending and production have softened**," but also pointed out that job gains "have been robust in recent months, and the **unemployment rate has remained low**." Powell said that he **did not believe the economy was in recession**, citing a **"very strong labour market"** as evidence.
- Fed Chairman also added that they are also **continuing with the process of significantly reducing the size of its balance sheet.**

U.S. Inflation peeking

The US consumer price index rose by **9.1% in June** from a year earlier, topping forecasts and hitting a fresh four-decade high. High inflation had briefly fueled **speculation that the Fed would lift rates by a full percentage point this month**. But those bets got called back after Fed

U.S. Inflation touched a fresh 4 decade high of 9.1% in Jun '22



Source: tradingeconomics.com

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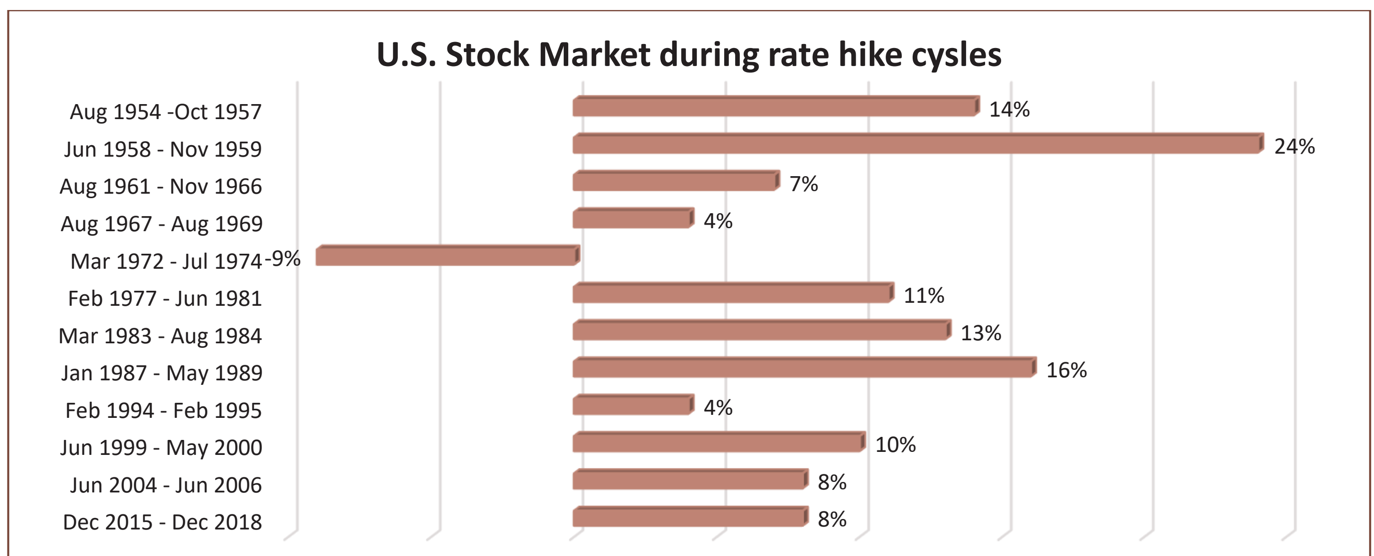
officials voiced caution and key readings on consumer expectations for future inflation were better than expected.

To Conclude

In reaction to the hawkish stance of the Fed the U.S. equities – denoted by the **S&P 500 rallied ~2.62%,** while the **10-year U.S. Treasury yield softened to close at 2.79% on Wednesday after being range bound throughout the day**. Back in **India the equity markets were in the green while the debt market remained flat.**

History of 12 U.S. rate hike cycles have proven that the S&P 500 has risen by an average annualised rate of 9.4%.



Source: Moneycontrol

In India the rising US interest rates present **challenges for the RBI Governor** as inflation in the domestic market is showing signs of receding. When the Fed raises its policy rates, the difference between the interest rates of India and the US narrows. This makes emerging countries such as India less attractive for the currency carry trade. Thus, the **market expects the RBI to hike rates above the pre-covid levels of 5.15%, by 35-50 bps from 4.90% presently, as it would need to ensure that the interest rate differential between India and the U.S.** to attract dollar at a time when India is expected to witness a record current account deficit. Further, a weakening rupee will put **pressure on inflation via higher cost of imported goods** and services.

We believe **market may remain volatile on back of interest rate hike by Fed, the Ukraine & Russia conflict, and its effect on global inflation.** With further rate hike are on the cards for most of major developed economies across the world **fear of "stagflation" are at their highest** since the onset of the Great Recession in 2008. The investors should **follow the desired asset allocation** to avoid unfavourable portfolio outcomes in case of any volatility that flows in the Indian markets due to tapering.

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