The Fed chose the quarter point increase, lifting the federal funds rate to a range of 4.75%-5.0%, marking the ninth increase in consecutive meetings totaling 4.75 percentage points. Fed chair Powell also indicated that at least one more increase is likely, lifting the funds rate above 5 percent for the first time since 2007. Interestingly, Powell suggested that even more increases would be in the cards if not for the tightening of credit conditions. In essence, the Fed leader is saying that the indirect effects of the Fed's actions are having the same restrictive effect on the economy as would another quarter or half percentage point rate increase.

Critics of the move believe an increase was unwise as it risks amplifying stress on the banking system. In their eyes, that threatens to do more harm than the potential increase in inflation pressures that might occur by leaving rates unchanged. Time will tell, of course. Whether it hikes again and leaves rates at higher levels for the rest of the year, as it signaled at the policy meeting is another matter. The financial markets a re nonbelievers, as traders are pricing in several rate cuts before the end of the year, convinced that the combination of higher rates and tighter credit conditions will usher in a recession over the second half of the year.

Hiking Until Something Breaks

No doubt, the Fed's plan to keep raising rates heightens the risk that it will cause more serious damage to the economy and financial system than is acceptable. However, the Fed's long-standing goal to restore price stability – defined as a 2 percent inflation rate – has so far been elusive. Some modest progress has been made, but it would be a mistake to think that inflation continues to recede on its own if the Fed moves to the sidelines. To drive a stake into the heart of inflation, something would have to break, either an abrupt downshift in the job market that weakens wage pressures and/or a marked falloff in consumer demand that reduces business pricing power.

At most, the economy's trajectory is bending but nothing of significance is breaking. Even the housing market that has been clobbered by surging home prices and mortgage rates is stabilizing, as sales have rebounded in recent months. But the more important spheres of influence are still going strong. The labor market remains historically tight, with unemployment at around 50-year lows and far more job openings than unemployed workers available to take positions. Wage increases are running at about 6 percent, which, assuming productivity growth of 1.5 percent, would need to slow to 3.5 percent to be consistent with a 2 percent inflation rate.

Meanwhile, businesses have not only been able to raise prices enough to cover rising labor costs, they've also, until recently, expanded profits in the process. However, that dynamic is changing, as a growing swath of households are running out of the excess savings accumulated during the pandemic and are resisting price hikes, prompting some pullback in spending. That has weakened business pricing power somewhat, contributing to the modest slowdown in inflation over the past several months.

But instead of cutting labor costs, employers are holding on to workers and accepting narrower profit margins, hoping to avoid labor shortages when demand re accelerates. True, many high-profile tech companies that have been hit hard by higher interest rates and a post-pandemic shift in spending habits have announced huge layoff s. But those workers are easily finding jobs elsewhere, which is sustaining both the tightness in the broader labor market and sturdy wage growth.

How Much Pain is Needed

Clearly, if profit margins narrow too much, companies will have no choice but to start purging their workforce. The Fed is apparently willing to accept some increase in joblessness; indeed, it is projecting a 1 percent increase in the unemployment rate over the next year to 4.6 percent. A rise of that magnitude has always occurred during a recession, but a 4.6 percent unemployment rate would still be low historically and hardly consistent with a sharp wage slowdown. Some respected economists believe that unemployment has to rise to 6 percent or higher to cut wage growth to 3.5 percent, which would translate into 2.5 million more unemployed workers than otherwise.

However, the Fed is counting on a normalizing job market to do some of its work. One helpful assist would be to get more workers off the sidelines, lifting the labor force participation

rate back to where it was prior to the pandemic. That trend is underway, particularly among prime-age women whose participation rate has already surpassed its pre-pandemic peak. More supply of labor means more competition for jobs, which presumably would lower wage pressures. Still, the participation rate among prime-age men is half-percent below the pre-pandemic peak and getting them back is critically needed to ease labor shortages.

But restoring a balance between demand and supply of labor requires changes on the demand side as well, and this is where forecasting how much joblessness would be required to ease wage pressures becomes difficult. The pessimists who think unemployment needs to rise to 6 percent assumes that employers would have to cut millions of jobs to undercut worker bargaining power. However, The Fed believes that job cuts of that magnitude is unnecessary, since the demand for workers is being amplified by the huge excess of job openings over job applicants. Just by reducing job listings, a better balance between labor supply and demand can be restored while minimizing actual job cuts. As workers see that job opportunities are less plentiful, they will temper their wage demands and give more priority over job security, particularly as economic activity slows.

A Looming, But Mild Recession

The Fed makes decisions based on incoming data, which are backward looking and do not reflect the cumulative impact of the sizable rate hikes put into place over the past year. Households and businesses are only now adjusting to a higher rate environment and their future behavior may change more profoundly than the Fed expects. This is the long and variable direct impact that has yet to fully play out.

More important is the indirect effects that are now surfacing because of the aggressive rate hikes over the past year. Even assuming, as we do, that the banking stress will be contained by vigilant macro prudential policies, the indirect effects may cause more pain than is currently envisioned. Even Fed chair Powell admits to uncertainty over how restrictive credit conditions may become as banks become more discriminating lenders. Against this backdrop of higher rates and reduced credit availability, the economy is likely to fall into a recession later this year. But if the Fed stops hiking rates in a timely manner and further external shocks are avoided – a big if – the downturn should be mild as the Fed succeeds in breaking something without causing a crash.

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ECONOMIC INDICATORS

	February	January	December	November	October	September	August	12-Month Range High	Low
Prime Rate	7.74	7.50	7.27	6.95	6.25	5.73	5.50	7.74	3.37
3-Month Treasury Bill Rate	4.65	4.54	4.25	4.15	3.72	3.13	2.63	4.65	0.44
5-Year Treasury Note Rate	3.94	3.64	3.76	4.06	4.18	3.70	3.03	4.18	2.11
10-Year Treasury Note Rate	3.75	3.53	3.62	3.89	3.98	3.52	2.90	3.98	2.13
30-Year Treasury Bond Rate	3.80	3.66	3.66	4.00	4.04	3.56	3.13	4.04	2.41
Tax-Exempt Bond Yield	3.70	3.46	3.65	3.76	3.93	3.86	3.43	3.93	2.73
Corporate Bond Yield (AAA)	4.56	4.40	4.43	4.90	5.10	4.59	4.07	5.10	3.43
Conventional 30-Year Mortgage Rate	6.26	6.27	6.36	6.81	6.90	6.11	5.22	6.90	4.17
Dow Jones Industrial average	33648	33656	33482	33418	30571	30650	33010	34315	30571
S&P 500 Index	4080	3961	3912	3917	3726	3851	4159	4391	3726
Dividend Yield (S&P)	1.73	1.68	1.70	1.65	1.73	1.85	1.67	1.85	1.40
P/E Ratio (S&P)	19.0	19.3	18.2	19.3	18.7	17.3	19.3	22.8	17.3
Dollar Exchange Rate (vs. Major Currencies)	120.3	119.8	122.3	125.0	127.6	125.7	122.4	127.6	116.4

* Monthly Averages

Economic Indicators

	February	January	December	November	October	September	August	12-Month Range High	Low
Housing Starts (Thousands of Units)	1450	1321	1347	1419	1426	1465	1508	1805	1321
New Home Sales (Thousands of Units)		670	625	583	589	550	646	707	543
New Home Prices (Thousands of Dollars)		428	466	458	497	478	441	497	428
Retail Sales (% Change Year Ago)	5.4	7.7	6.3	5.9	8.0	8.4	9.7	10.00	5.4
Industrial Production (% Change Year Ago)	-0.2	0.5	0.6	1.8	3.0	4.7	3.5	5.3	-0.2
Operating Rate (% of Capacity)	78.0	78.0	77.9	79.1	79.7	79.9	79.8	80.2	77.9
Inventory Sales Ratio (Months)		1.34	1.36	1.35	1.33	1.33	1.33	1.36	1.28
Real Gross Domestic Product (Annual % Change)			2.7			3.2		3.2	-1.6
Unemployment Rate (Percent)	3.6	3.4	3.5	3.6	3.7	3.5	3.7	3.7	3.4
Payroll Employment (Change in Thousands)	311	504	239	290	324	350	352	568	239
Hourly Earnings (% Change Year Ago)	4.6	4.4	4.8	5.0	4.9	5.1	5.4	5.9	4.4
Personal Income (% Change Year Ago)		6.4	5.6	5.6	5.7	5.6	4.2	5.7	-12.1
Savings Rate (Percent of Disposable Income)		4.7	4.5	4	3.4	3.0	3.2	4.5	2.7
Consumer Credit (Change in Blns. Of Dollars)		14.8	10.7	36.1	35.0	25.4	29.2	45.3	6.3
Consumer Prices (% Change Year Ago)	6.0	6.4	6.5	7.1	7.7	8.2	8.3	9.1	6.0
CPI Less Food & Energy (% Change Year Ago)	5.5	5.6	5.7	6.0	6.3	6.6	6.3	6.6	5.5
Wholesale Prices (% Change Year Ago)	4.6	5.7	6.5	7.3	8.2	8.5	8.6	11.7	4.6