Federal Reserve Expected to Stay Aggressive

Despite lower prices at the pump last month, the Labor Department's consumer-price index (CPI) for August showed little improvement, which is expected to force the Federal Reserve to maintain its aggressive monetary policies for longer than most market participants were anticipating.

The Labor Department reported on Tuesday, September 13 that the CPI increased by 8.3% in August from a year earlier. While it is encouraging that the increase is lower than the 9.1% increase in June and the 8.5% increase in July, it was higher than what the market expected. Furthermore, on a month-over-month basis CPI was up 0.1%, and the so-called core CPI, which does not include the impact of energy and food prices, was up 0.6%.

Markets responded quickly to the CPI release with the S&P 500 initially shedding 2.0% before it ended the day down over 4.0%, yields on U.S. Treasuries increased across the curve (yields up, prices down), and gold, Brent crude, and many other commodities moved lower. However, one notable asset that has performed well this year and saw its relative value generally move higher after the CPI release is the U.S. Dollar.

Strong U.S. Dollar

Although the Federal Reserve has acknowledged it was slow to respond to rapid inflation last year, it has been more aggressive than many other major central banks this year. The Fed's aggressive policies and the relatively strong U.S. economy are factors that have helped the U.S. Dollar strengthen significantly against many other currencies as evidenced by the WSJ Dollar Index, which measures the dollar against a basket of other currencies, being up approximately 13% year to date. If fact, certain currencies are trading a multi-decade lows versus the dollar such as the British Pound (1985), Japanese Yen (1998), and the Euro (2002).

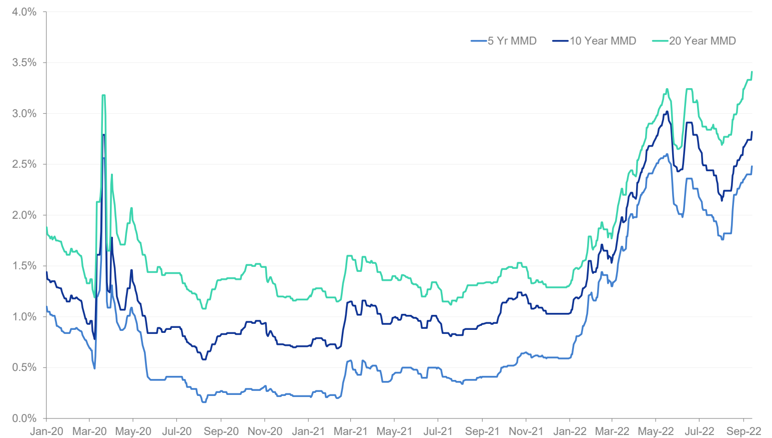
Certain central banks now face the challenge of keeping pace with the Federal Reserve to protect their currencies and slow down inflationary pressures, at a time when their economies face challenges beyond what the U.S. economy is experiencing (e.g., Russia's invasion of Ukraine or falling commodity prices for emerging market economies). While a strong dollar helps to offset inflationary pressures for U.S. consumers, rapid and material changes to exchange rates can create negative economic ripples through the global economy.

Next Week's FMOC Meeting

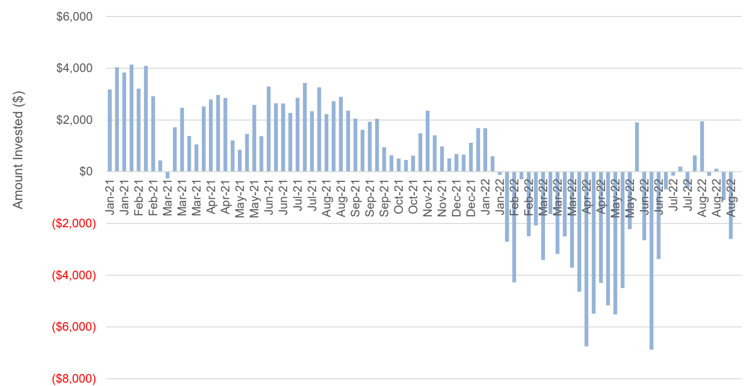
Markets are currently pricing in a minimum increase of 0.75% to the overnight rate, with a 36% probability of a full 1.00% increase, as a result of the Federal Open Market Committee (FOMC) meeting to be held September 20-21. A 75-basis-point increase would move the fed funds rate range to 3.00%-3.25%. We would expect markets to be particularly interested in the Fed's post FMOC meeting comments regarding any changes to its expectations on how high it might need to take the overnight rate to get inflation to an acceptable level.

Municipal Market Update

Interest rates on municipal bonds continue to exhibit volatility after steadily moving higher during the first five months of the year as illustrated by the following chart which provides Municipal Market Data (MMD) AAA yields since the start of 2020 for 5-year, 10-year, and 20-year maturities. Rates have generally increased since the first week in August, largely in sympathy with U.S. Treasuries.



Despite the occasional week of net purchases that tend to coincide with a falling rate environment, investors continue to sell municipal bonds with net municipal bond outflows occurring in 28 of the past 33 weeks.



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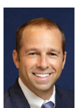
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