Fed Tightening Is Having More Impact Than You Might Think

By Randall W. Forsyth

We’ve learned a lot about the transmission of disease in the past few years. Ideas, good and bad, are spread similarly.

Robert Shiller, the Yale University Nobel laureate, wrote in *Irrational Exuberance* of the epidemic model of the spread of information. The now-classic book about investment manias was published two decades ago, in the infancy of the World Wide Web and email, both of which accelerated direct person-to-person transmission of ideas. Moreover, Shiller noted, those ideas spread even more powerfully if accompanied by a “good, vivid, tellable tale” and without dry analysis from experts who might inject caveats.

Such epidemiology helps explain the boom in cryptocurrencies and their subsequent bust, exemplified by the implosion of FTX, the crypto exchange formerly headed by supposed wunderkind Sam Bankman-Fried. Indeed, “going viral” has entered the lexicon for an exciting idea catching on rapidly everywhere.

This sort of craziness is nothing new. Indeed, the tale of alchemists figured prominently in the 19th-century classic, *Extraordinary Popular Delusions and the Madness of Crowds* by Charles Mackay. There would seem to be a philosophical line from the medieval dream of turning base metals into gold to the modern one of turning computer code into riches. (Cryptocurrency aficionados could counter that modern money is simply paper with no backing, the supply of which central banks can expand without limit.)
the bubbles can deflate, leading to busts such as the house-price crash during the 2008-09 financial crisis.

Indeed, Evercore ISI, led by the redoubtable Ed Hyman, suggested in a client note on Friday that the FTX fiasco could be a sign that Federal Reserve policy has become restrictive. A proxy federal-funds rate calculated by the San Francisco Fed, which takes into account quantitative tightening (the contraction of the central bank’s balance sheet), puts the key policy rate at 6.34%, compared with the nominal target range of 3.75%-4%.

Another sign of tight Fed policy, according to Evercore ISI, is that the fed-funds rate is trading above bond yields. The benchmark 10-year Treasury yield on Friday was little changed on the week at 3.82%, but had traded below 3.70% at midweek, briefly putting it beneath the low end of the fed-funds target range. Such an inverted yield curve, with long rates lower than short ones, is a classic portent of an economic downturn. But Campbell Harvey, a Duke University professor who popularized this interest-rate theory, emphasizes in the transcript of a video with Research Affiliates that the inversion must persist for at least a quarter to signal a recession.

A parade of Fed speakers this past week suggested that they are prepared to lift the key policy rate further, which accords with the pricing in the fed-funds futures market. After four 75-basis-point boosts, a 50-basis-point hike at the Dec. 13-14 Federal Open Market Committee meeting is priced into the futures, according to the CME FedWatch tool. (A basis point is 1/100th of a percentage point.) That would be consistent with Fed Vice Chair Lael Brainard’s comment that a slower pace of increases seems appropriate.

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She also has suggested that further rate increases will be needed. Futures prices point to a peak fed-funds target of 5%-5.25% by next March, holding there until next November. Markets were roiled by a suggestion by St. Louis Fed President James

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The prospect of further Fed tightening and the likelihood of flat-to-lower corporate earnings have Wall Street strategists issuing unusually conservative stock-price targets. Major indexes such as the S&P 500 SPX -0.37% could end 2023 about where they stand currently after a volatile roller-coaster ride. Those forecasts also are predicated on the Fed easing later next year.

Implicit in that outlook is that peak 5% short-term rates will rein in inflation, still running at almost 8%. Could that also be a bit of fanciful thinking?

Write to Randall W. Forsyth at randall.forsyth@barrons.com

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