Situation analysis June 14, 2023

Fed keeps rates steady, projects more rate hikes and inflation later this year

Key takeaways

- The U.S. Federal Reserve (Fed) held interest rates steady in a range of 5.00% to 5.25% today after an aggressive rate hiking campaign initiated in March 2022.
- The Fed projects sticky inflation in the second half of the year and, in a surprise to investors, an additional 0.5% in rate hikes in 2023.
- Interest rate markets now imply higher odds of additional rate hikes this summer, and a longer period of high rates following the Fed's hawkish guidance today.

The Federal Reserve held its target federal funds interest rate steady in a range of 5.00% to 5.25% following its regularly scheduled two-day meeting but signaled more rate hikes remain likely at future meetings. Interest rate policy represents the primary tool the Fed uses to carry out its mandates of maximum employment, stable prices and moderate long-term interest rates. Gradually decelerating inflation data paired with the acknowledgement that monetary policy works with "long and variable lags" contributed to today's pause following an aggressive policy tightening campaign the past 15 months. However, the Fed projects a more challenging environment of slow growth and sticky inflation, plus 0.5% of additional hikes this year, an outlook that dragged on investor sentiment today.

The Fed's updated Summary of Economic Projections upgraded 2023 economic growth expectations but downgraded growth for 2024 and 2025 while acknowledging inflation may remain sticky. The most important surprise to investors was the projection for 0.5% in additional rate hikes in the remainder of 2023 to a median of 5.6%, up from the Fed's most recent projections in March for a 2023 year-end median of 5.1%. The increase in members' rate hike projections reflects their collective view that policy must tighten further to restrain troublesome price increases. The Fed's official statement also hardened language around rate hikes and Chairman Jerome Powell noted, "Nearly all (committee) participants think further rate changes will be necessary." Powell also said, "(Inflation) has not reacted much to our existing rate hikes. We're going to have to keep at it," referring to additional rate hikes.

The Fed continues to reduce its Treasury and mortgage bond holdings, which reached as much as $8.5 trillion during its attempt to suppress interest rates during the COVID pandemic. In addition to restraining post-pandemic bond yields and encouraging borrowing, the Fed's bond buying also converted bonds held by market participants to cash, which can support economic activity through added liquidity. Starting last year, the Fed began allowing up to $95 billion per month to mature or "run off" its balance sheet, forcing investors to absorb the incremental supply. Bond portfolio runoff has the potential to nudge bond yields higher (which move in the opposite direction of bond prices) and dampen liquidity, in turn reducing a portion of the fuel available for future economic growth. Congress's recent debt ceiling resolution allows the U.S. Treasury to issue a flurry of Treasury bills, notes and bonds to replenish cash balances used to fund normal government spending. The Fed cited target account balances of $425 billion by month-end and $600 billion by the end of September, versus a current balance around $100 billion, necessitating significant new government debt issuance in the next two weeks. The large amount of issuance necessary to reach the Fed's month-end goal may further drain liquidity from the financial system as investors and financial institutions purchase government bonds with cash, and that cash moves to the Treasury's account. Lower liquidity has historically correlated to lower-than-average stock market returns.

Stock prices fell immediately following today's Fed announcement due to the strong signal for additional rate hikes this year but recovered to end the day nearly unchanged, with the S&P 500 up 0.08%. Stocks outside the U.S. outperformed domestic stocks. Treasury bond yields were mostly higher on higher rate hike expectations. Ten-year Treasury yields fell 0.02% to 3.80% (well below 2022 highs near 4.25%). The two-year Treasury yield rose 0.03% to 4.70% as investors priced in a higher path of interest rates. The two-year yield remains below 2022 highs near 4.75%.

Monetary policy, defined as central bank interest rate target decisions, continues tightening around the globe as inflation remains uncomfortably high. Investors expect an additional 0.50% to 0.75% of rate hikes from the European Central Bank this year, along with 1.25% of rate hikes from the Bank of England. The second quarter is poised to reflect the total number of rate hikes minus the number of rate cuts fell by half versus the first quarter, though remains on a trajectory of tighter rates. The slower pace of hikes reflects both the aggressive pace of hikes that already occurred last year and early this year, along with the gradually moderating pace of inflation. Consensus expectations indicate subdued global growth for upcoming quarters, though economists expect the global economy will narrowly avoid recession or experience only a mild contraction in activity. Global purchasing manager surveys and economic growth data indicate a considerable divergence between services (improving and now expanding) versus goods (contracting but modestly improving from recent levels) around the globe.

Most global stock and bond market indices are positive on the year following a challenging 2022. Today's Federal Reserve announcement complicates the outlook, since its projections call for further monetary tightening measures to tame sticky and problematic inflation. Our proprietary analysis suggests the path forward for consumer activity and corporate earnings may remain under pressure. However, markets have proven resilient year-to-date and consumer spending has surprised to the upside. We will keep you informed of our views as we progress through 2023.

As always, we value your trust and are here to help in any way we can. Please do not hesitate to let us know if we can help address your unique financial situation or be of assistance.