The Federal Reserve Open Market Committee raised the Fed funds rate today by 0.25% to a range of 4.50-4.75%. The vote was unanimous, and continued a deceleration in tightening, after four straight 0.75% moves in 2022, and capped by 0.50% in December. Last year's hiking pace was the fastest and steepest since the early 1980s.

The formal statement language noted that overall indicators point to modest growth in spending and production, with job gains being robust, and unemployment remaining low. Importantly, they note that inflation has 'eased' (a change from the Dec. statement, with 'pandemic' effects being removed) with the Russia/Ukraine war still contributing to global uncertainty. They also noted that further rate hikes would be appropriate, although the overall language appears tamer than last year.

According to CME Fed funds futures[1], probabilities pointed to an over-99% chance of a quarter-percent change, with chances of a half-percent hike having steadily fallen as inflation has slowed as well as recent more dovish Fed commentary. Looking at the rest of the year, another 0.25% is expected by March (to 4.75-5.00%). By June, the highest odds point to a pause, which stays intact through Sept., while odds for Dec. show either a -0.25% or -0.50% drop from the peak level. Therefore, 5.00% still remains the expected 'terminal rate'. The drop-off in late 2023 has remained consistent from recent Fed meetings and coincides with expectations for the U.S. economy to fall into recession.

One of the more important things investors seemed to be looking for was a signal for the rest of 2023. Last week, the Bank of Canada raised rates by 0.25%, as expected, but also anticipated a pause to assess impacts of the hiking policy thus far. While their target range is a bit looser than in the U.S., the Canadian economy is also more cyclical (energy/materials-based), and has suffered more on the residential real estate side, with prices down in the double-digits in some key cities. By contrast, the Fed seems more reluctant to 'call the top' in rates, so to speak. Bond markets don't necessarily agree with a long pause, with the 10-year U.S. treasury now having fallen from highs over 4% in October to just under 3.5% today. Shorter-term yields have come down as well, keeping the treasury yield curve version intact. Financial conditions metrics have generally remained tempered, with makes the Fed's tightening job even more challenging.

<u>Economy</u>. The preliminary growth rate for Q4-2022 came in at 2.9%, which was a bit better than expectations. But that's old data now, with the Atlanta Fed's GDPNow[2] estimate for Q1 now at 0.7%. The same questions fester: is recession coming this year and how bad could it be? This may be the most anticipated recession in decades, although there is substantial dispersion around the likelihood of one—anywhere from one-third to over two-thirds of a chance. Classic indicators such as manufacturing ISM, services ISM, industrial production, and retail sales have all been declining, and pointing to a downturn. On the consumer side, government stimulus payments from the pandemic are running out, with signs of some strain in auto loans and rising credit card balances, which face the combined effect of the debt principal itself but also higher financing rates. (This is where Fed policy finds its way to the consumer, pulling the reins on demand.) On average, when a recession arrives after Fed rate hikes begin, it normally occurs within 2 years. Of course, a recession can also end up being a self-fulfilling prophecy if consumers and businesses stop spending, due to fear that one that one is coming, which can bring one into existence. The Fed seems to be willing to absorb this growth weakness for now, but a

stand-off remains with markets, which expect it to eventually blink and pause or cut rates this year (as reflected in futures markets and treasury yields). A more recent wrinkle is renewed hopes for a soft landing, as last year's rate hikes haven't caused the economy to fall off a cliff yet, but inflation is still behaving by decelerating. Soft landings haven't been common when the Fed hikes rates, but they have happened if conditions happened to align. Global effects have helped, with a warmer winter in Europe pulling down natural gas prices and the reopening in China unleashing pent-up demand. While the U.S. tends to be globally more self-sufficient than many other economies, these help growth more than hurt.

<u>Inflation</u>. Per the December CPI[3] report, trailing 12-mo. headline and core inflation slowed to 6.5% and 5.7%, respectively. (For reference, the June 2022 peak for headline CPI was 9.1%.) Core PCE[4] inflation, which the Fed focuses on and has a different composition, has also decelerated to 4.4%. No doubt, year-over-year inflation rates have improved, but aren't yet close to where the Fed wants them to be. Goods inflation has continued to fall off at a faster rate, which is the good news, representing repaired supply chains from the pandemic, but also due to consumers 'full up' on physical items purchased the last few years. Though, for services, which represents 70% of the economy, inflation has been stickier and driven to a larger degree by labor costs. Consumer prices slowing in the pace of rate hikes has been an acknowledgement of the Fed's efforts in slowing demand, but it remains to be seen what a durable 'new normal' for inflation looks like—whether it's 3.0%, 2.5%, 2.0%, or even an unanticipated below-target reading. There are cogent arguments on both sides of the debate for inflation staying higher than the 2.0% target (smaller labor force, globalization turning toward regionalization, and energy transition from fossil fuels to green) or falling below if conditions overcorrect (seen now in used cars and energy), making the Fed's job even harder with a single blunt tool of rate policy.

Despite the focus on the Fed alone leading the inflation-fighting battle, other economists (such as John Cochrane, for example) point out that keeping inflation contained in the longer term requires not only the Fed's monetary policy actions, but also strong coordination with government fiscal policy. Stronger GDP growth can help as a third factor, although that is also tied in closely to demographics and productivity. Looking back, the inflation episode of the early 1980s was thought to have been brought down by Paul Volcker's Fed leadership efforts alone, but also occurred in conjunction with deregulation and fiscal spending changes, such as Social Security and tax reform, along with stronger economic activity. Growing perceptions that government spending can continue to creep higher unchecked have again eroded confidence in long-term financial sustainability, although this has been a problem globally, not just in the U.S. There has been begrudging acknowledgement by many economists that pandemic stimulus, and creation of money behind it, has fueled far more of the inflation problem than was initially thought, which explains its persistence.

<u>Employment</u>. Labor indicators generally remain robust relative to history, even though some weakening has been seen at the edges, such as slightly higher jobless claims. The market for skilled labor remains tight, causing employers to be hesitant to lay off hard-to-find key workers only having to rehire them back if a downturn is short-lived. Additionally, several states have announced increases in their minimum wage effective Jan. 1, which flows through as higher wage gains. Announcements from several large technology firms haven't morphed into broad-based layoffs in other industries (as of yet), but carryover remains a risk. While the Fed doesn't

want to be put on record allowing U.S. households to suffer needlessly, 'expecting' the unemployment rate to rise as it fights inflation is surrendering to this weakening effect, as in something has to give. But, all in all, labor remains the strongest part of the economy, with much of the hope for a 'soft landing' based on that segment.

Over the history of modern central banking, it has proven very difficult to raise rates sharply enough to fight inflation without ultimately causing a demand-driven recession—although not impossible. Expectations for another small hike or two and then a pause remain the base case in 2023. A slowing in the hiking pace, any dovish Fed communications, and greater certainty around the terminal rate level could bring clarity/less volatility to financial markets this year. There has been debate in the economic community about when impacts from tightening cycles reach their peak, which seems to be within 6 mo. and 1 yr. from the start of hiking, so we may already be on the downhill slide.

However, the rate inputs don't operate in a vacuum, with concerns both domestic (debt limit debate) and geopolitical (China growth, Russia/Ukraine). Stocks tend to hinge hopes on discount rates, with expectations capped by minimal earnings growth expected in 2023. But, sentiment can also react well before we might assume to any optimism about the new cycle lying just beyond the current slowdown (this has already occurred in Europe and the emerging markets due to a worst-case scenario being avoided), so 2024 is already being talked about as a decent recovery point. Stocks have fared well historically after the peaking of both inflation and Fed funds rates, with earnings growth (or lack thereof) remaining the 2023 wildcard. Bonds already have begun to benefit from higher starting rates, which bodes well for multi-year returns looking ahead.

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Sources:
[1]CME Group (https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html)
[2]Federal Reserve Bank of Atlanta (https://www.atlantafed.org/cqer/research/gdpnow.aspx)
[3]U.S. Bureau of Labor Statistics (https://www.bls.gov/cpi/)
[4]U.S. Bureau of Economic Analysis (https://www.bea.gov/data/income-saving/personal-income)