The Federal Reserve Open Market Committee unanimously raised the fed funds rate today by 0.25% to a range of 4.75-5.00%. Starting from 0.00% just a year ago, this continues to be the quickest and most robust hiking cycle since the early 1980s.

The formal statement language, importantly, saw removal of the reference to "ongoing" rate increases, replaced by "will closely monitor" and "anticipates that some additional policy firming may be appropriate." It also described the U.S. banking system as "sound and resilient," and that credit conditions are likely to weigh on economic activity—no doubt recently added. Also, that job gains are running at a "robust" pace. Overall, this was taken as a bit dovish for a hike, and stocks turned higher immediately upon its release. In the Fed's updated Summary of Economic Projections (SEP) or 'dot plot' today, fed funds rates projections were little changed, with the 2023 median level just above 5.0%, 2024 remaining around 4.0%, and 2025 down toward 3.0%—all implying normalization.

CME fed funds futures[1] have fluctuated more wildly than usual in the past two weeks, with changing opinions about how banking industry woes could force the Fed to change course. In early March, a long-assumed quarter-percent hike moved to a more definite half-percent after Fed Chair Powell's hawkish Congressional testimony about inflation's persistence. Just days later, targeted aid to several troubled banks seemed to take that faster pace off the table (in no small part because higher rates contributed to banking issues). Yet, by this morning, odds of 0.25% again moved to nearly 90%, as a potential pause faded away. (Odds had been as tight as 50/50 over the last week, showing the high number of divergent views on this.) For the peak terminal rate, assumed to be reached in mid-2023, futures have shifted from expectations of just under 6.00% now down to a brief stay around 5.00%. The base case now shows late 2023 rate cuts, as pessimistic views of economic growth have dropped the highest probability point back down to around 4.50%. While it's way too early for year-end 2024 probabilities, this is the furthest out CME offers, showing fed funds at around 3.00%.

This was perceived to be difficult meeting for the Fed in the sense that no matter what decision was made, there would be criticism from some corner. Fed policy expectations *had* been fairly steady—that investors could take the Fed at their word, and inflation-fighting would remain the key focus. However, with banking system concerns ramping up this month, the Fed's mandate of financial stability turned attention toward more fundamental systematic concerns. These proved not strong enough to force a hiking pause, either temporarily, or to end the cycle completely. The ECB, faced with bank stresses of their own, chose to keep hiking by 0.50%, showing that inflation remained number one on the to-do list. Ironically, if a variety of central banks were to pause, it could have exacerbated worries across markets (as in, "Considering how hawkish they were earlier in the month, things must be really bad for everyone to change course so soon?"). In looking at the past 60 years, though, the Fed has not necessarily eased immediately in light of financial stresses 'breaking' the economy—only in about half of cases. The 'separation principle' appears to be what the Fed is working under—that they can tackle separate issues at the same time with different tools.

Economy. After a year of rising rates, recent stress on regional banks, including even a few bank failures, concerns have risen over the vulnerability of core economic activity. Historically, the intention of tighter policy has been to slow economic growth, which would qualify in this cycle as well (no one said it was pleasant-tasting medicine). While growth has been pressured by both inflation and the Fed, the banking sector now being under more scrutiny may also start to reduce the availability of credit. Banks with assets under $250 bil. (a current regulatory line between 'large' and 'small') represent half or more of all U.S. lending, making perceptions of their health quite important. In effect, slower lending would likely further slow spending (perhaps by up to 0.50-0.75% from GDP growth), creating another headwind that's again raised recession chances.

Otherwise, though, the economy isn't in bad shape. Based on the familiar Atlanta Fed GDPNow[2] measure, the latest Q1 growth estimate is 3.2%, a pace that's been rising steadily this quarter, and led by strong consumer spending. In the Fed SEP, median GDP growth was downgraded slightly to 0.4% in 2023, by almost a half-percent to 1.2% in 2024, and upgraded by a tenth to 1.9% in 2025. The latest ISM manufacturing number remains in contraction in the high 40's, but has improved from lows. ISM services remain robust, falling in the expansionary mid-50's. Even prior to the banking woes, recession odds continued to vary dramatically among economists, with chances anywhere from one-third to two-thirds in the coming year. If/when a recession comes, it might be described as the most widely anticipated in years, with still-significant uncertainty as to whether it happens in 2023, is delayed until 2024, or doesn't happen at all (coveted soft landing).

Inflation. Prices remain sticky, although the pace has continued to decelerate from last year's peak. In the most recent February CPI[3] report, the year-over-year change slowed to 6.0% for headline and 5.5% for core. Trailing 12-mo. CPI is dictated by levels at both the starting and ending dates; as such, it is expected to move down more dramatically over the next few months, all else equal. The Fed's preferred measure of Core PCE[4] has stayed in a consistent range, at 4.7%. The Fed SEP showed an upgrade to PCE inflation to 3.3% this year, and no changes for 2024 (2.5%) or 2025 (2.1%). While these indications offer hope, high inflation levels overall remain problematic for the Fed. One issue is that housing costs carry a significant weight in U.S. inflation indexes. While more current data for rent and house prices has shown deceleration, CPI shelter inputs experience a longer lag time in measurement. On the positive side, wage growth has shown signs of stabilization recently, reducing the potential of a wage-price spiral and potentially higher inflation expectations (which have also declined).

Employment. The labor market remains the sweet spot in the U.S. economy, and little has changed over the past several Fed meetings. The Fed SEP expectations for the unemployment rate were optimistic, showing no change from the Dec. figures: 4.5-4.6% for the next three years. A shortage of workers due to demographic and pandemic reasons has kept payrolls high, unemployment low, and consistent readings for job openings and jobless claims, etc. Recessions have historically pushed the unemployment rate sharply higher, but the severity of job loss in this cycle remains in doubt due to structural tailwinds.

After a year of interest rate hikes, it's reasonable to ask where yields across the treasury curve should ultimately end up. Long-term historical averages point to short-term T-bills earning about 0.5% in real yield, while longer-term bonds have earned about 2.0% real. Assuming the Fed's 2% target for inflation and expectations can be reached, yields of 2.5% and 4.0% could look appropriate. In fact, the Fed continues to use 2.5% as their long-term neutral fed funds rate. For the more hawkish, using 3% as an inflation rate, 3.5% and 5.0% look more suitable. Conventional monetary policy thinking states that interest rates need to rise well above the inflation rate to slow the economy enough to get inflation beaten back down. In theory, this points to the Fed still moving a bit higher than current levels, although it also depends on how fast inflation decelerates—creating a more difficult moving target.

In short, the Fed may not be far from their ending point in this cycle, and current rates may not be all that far from where they 'should' be. Getting to that point would be welcome for those reliant upon more stable discount rates to value stocks and real estate. At the same time, rates falling from highs have tended to be a positive for financial markets looking forward, although they also go along with economic slowing, as one cycle ends and another begins. Falling rates would obviously also ease pressures on the banking system, punished by the current treasury yield curve inversion. Of course, more conservative bond and cash assets have been pulling their own weight in portfolios for the first time in a long while, with decent forward-looking return expectations for fixed income a new and welcome luxury for many investors.

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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/personal-consumption-expenditures-price-index-excluding-food-and-energy)