The Federal Reserve Open Market Committee raised the Fed funds rate today by 0.25% to a new range of 5.00-5.25%. The vote was unanimous. Starting from 0.00% just over a year ago, this continues to be the quickest and most robust hiking cycle since the early 1980s.

The formal statement was little changed from the March meeting but softened, and pointed further to a potential future pause. Economic growth was described as expanding at a 'modest pace' in Q1, job gains as 'robust,' and inflation as 'elevated.' The statement removed the reference to 'anticipates' policy firming (the key clue), while keeping 'will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments.' This might be described as a dovish hike of sorts.

Fed funds futures[1] markets this morning showed far less conviction than before recent meetings, as odds of a hike bounced between 75-95% over the past week. Future expectations point to little change over the summer, but a decent chance of a quarter-percent cut by late summer, and up to several cuts by December, to end 2023 around 4.25%. Perhaps surprisingly, the furthest-out futures for December 2024 show Fed funds down around 3.00%. A drop of that size seems extreme from today's perspective, but it reflects the math behind the scenes (a small chance of a sharp decline in economic conditions is enough to pull down the average). So, in the course of a few months, an assumed terminal rate of just under 6% has now stabilized at just over 5%. Based on market opinion at least, today's rate level could be very close to the cycle peak, but is still a moving target while inflation stays elevated.

Economy. Economic growth remains spotty, but positive, with weaker manufacturing but stronger services. U.S. GDP[2] for Q1 came in last week at 1.1%, a below-average pace versus estimates of around 2%. The closely watched Atlanta Fed GDPNow[3] measure for Q2 indicates a pace of 1.8% so far. A key concern that's changed from the last FOMC meeting is an expected tightening of credit, as banks become more conservative with asset and liability management in the wake of balance sheet stress and are less willing to take on credit risk—a common response as recession fears rise. Banks have frequently struggled during past Fed hiking cycles, so this year's woes are not unusual, nor are some outright bank failures. The total impact from tighter credit is hard to estimate in real time, but potential erosion in GDP growth could be between -0.25% and -0.75% of the total growth figure. (The tightening effect also does part of the Fed's job—of perhaps a hike or two roughly.) Banks have also been fighting deposit outflows from low-yielding savings accounts towards money market mutual funds, which are providing a decent yield advantage directly due to the Fed's efforts.

These stresses are why an inverted yield curve is so predictive of recession, as it helps create the conditions for it. The FOMC's 'dot plot' from March pointed to high recession odds, even if that result wasn't communicated directly. (A recession is essentially the only reason the Fed would lower rates that sharply.) Estimates of a slowdown in coming quarters remain moderate to high, perhaps as the most-anticipated recession in years, although it's certainly not a 'done deal.' If/when it does happen, whether it be later 2023, 2024, etc., the start of the new cycle could see growth converge around the long-term pre-pandemic trend level of around 1.5-2.0%. On a secular basis, and assuming inflation is tamed, this points to interest rates ultimately moving lower.

Inflation. The March CPI[4] report came in showing trailing 12-month headline and core inflation of 5.0% and 5.6%, respectively. The headline number did show improvement, pulled down by energy prices, while core remains sticky. PCE remains in the mid-4's. Inflation continues to be the largest driver of Fed action, even surpassing temptations to pause after March's banking woes (which were at least partially driven by the Fed's own actions of the past year). While inflation has decelerated to some degree, the risk of it persisting at a high level has kept the Fed vigilant in not stopping the process early (a mistake assumed to have been one of those made in the 1970's). Monetary theory points to a general need to raise policy interest rates above the rate of inflation for a time to combat it—right now, these levels are roughly aligned.

As we've noted before, monetary actions only control the demand side, not the fiscal supply side. As measured by M2, growth of the money supply has now been shrinking on a year-over-year basis. This is quite unusual, in that it hasn't happened in the modern era (and not since the 1930's), but matches the equivalent strangeness of the preceding extreme spike in M2 (a yoy rate of over 25% in early 2021) caused by the immense injection of pandemic stimulus. That money flood will take time to ultimately wash through the economy, and likely explains a fair amount of the persistence in inflation.

Employment. The unemployment rate has yet to break out of its trend in the mid-3's, although that's considered a lagging indicator. Jobless claims have risen a bit this year, other than the seasonality issues, but continue to look flat on a chart since late 2021. Nonfarm payrolls remain positive, having slowly trickled down over the past year. Thus, labor markets have not eroded dramatically on a broad level, although at the edges, conditions have been weakening a bit, most notably seen through a shrinkage in openings. A shortage of skilled workers has appeared to keep conditions tight for longer than would normally be expected per past cycles. This has given the Fed confidence that hammering away at inflation has not caused too much damage yet.

Every business cycle has a beginning and an end, even though transition points aren't obvious at the time. The path of Fed funds has a close connection to that cycle, as risk-free yields are a starting point for discount rates and funding costs. For any part of the economy sensitive to interest rate changes, the past year has been challenging from their pace and magnitude, with ultra-low or zero rates having defined the investment landscape and psychology for much of the last 15 years. Now, the story is evolving toward normalization. This, when considered more closely, and aside from the recent pain of inflation, should be celebrated. 'Normal' is boring for those seeing entertainment in short-term volatility in financial markets, but it indicates less uncertainty and an absence of crises. It also means that asset classes should again be priced based on fundamentals, with lesser chances of (and need for) the Fed coming to the rescue. Discount rates stopping their ascent to remain steady or drifting a bit lower are a positive in that landscape unveiling.

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