The Federal Reserve Open Market Committee raised the Fed funds rate today by 0.25% to a new range of 5.25-5.50%. The vote was unanimous. Starting from zero in March 2022, this 11th hike continued the quickest and strongest hiking pace since the early 1980s. The formal statement was minimally changed, with economic activity upgraded from 'modest' to 'moderate.'

Today's move was well-telegraphed, with Fed funds futures[1] market odds steadily rising from 80% to 99% in the past month. Though, with the recent deceleration in inflation, odds of another hike after today have fallen, in Dec. 2023, with just over a one-half chance of staying at 5.25-5.50% and one-third chance of another 0.25%. Next year remains a different story, with June 2024 showing 4.75-5.00% and December at 4.00-4.25%. While those rate assumptions are higher than a month ago, the large assumed decline in 2024 reflects strong Fed easing in response to nothing short of a recession, as well as continued downward inflation progress.

<u>Economy</u>. Economic growth has remained positive, with Q1 U.S. GDP[2] coming in 2.0%, and Q2 expected to fall at least in the trend range of 1.5-2.0%. Per the International Monetary Fund[3], U.S. growth of 2.1% in calendar year 2022 is expected to slow to 1.8% in 2023, followed by a weaker 1.0% in 2024. For the sake of context, expected U.S. growth is twice as strong as Europe's in 2023, but only two-thirds as strong as next year's estimate. The most critical condition that could stop rate hikes in their tracks, recession, has been kept at bay. There are still-mixed opinions about whether a recession will happen by the end of 2023, be pushed off until 2024, or won't occur at all. Today's lack of clarity reflects a split between the contraction in manufacturing and declining consumption of goods, while services activity continues to expand. However, there is some concern over consumer spending power looking forward as stimulus effects dwindle and consumer credit balances rise. Based on Fed member comments, the lack of recession indicates they would seem to prefer keeping rates at a sustained level for a time, opposed to potentially undoing their inflation-fighting efforts from the past year, unless a deeper downturn eventually demands it.

<u>Inflation</u>. The improvement in June CPI[4] was heavily focused on by markets, with trailing 12-mo. rates of change falling to 3.0% and 4.8% for headline and core, respectively. Final demand PPI decelerated even further, to a 12-mo. pace of only 0.1%. Shelter remains a challenging piece of CPI, taking up a large weight in the inflation bucket with still-persistent month-to-month gains, although there is a significant lag effect (other real-time data shows more slowing in new rents). At the same time, a shortage of single-family homes could well keep synthetic owners' equivalent rent costs from declining as quickly as in past cycles, since these are tied to home prices. All-in-all, inflation has continued to decelerate, but at a slower pace than the Fed would have expected by now, which has kept their discomfort levels high. The level of inflation considered acceptable by the Fed remains unclear, but would likely be under 3%, which may finally happen by 2024 if the current path continues.

<u>Employment</u>. After a pandemic period best described as 'unique,' business closures were followed by labor shortages upon reopenings. Job market dynamics have since begun to normalize and even weaken, but continue to be scarred by several labor supply challenges in a variety of industries. These include early retirements, lower immigration, enhanced unemployment benefits, and other temporary and permanent workforce exits. Job openings and payroll growth have fallen from highs, tied to slowed hiring needs, but, on the positive side, corporate layoffs have not ramped up as dramatically as one might expect, considering other classic indicators that signal recession. Anecdotally, this appears to be due to reluctance of businesses to lose valuable workers hard to quickly replace later. The unemployment rate remains at multi-decade lows (3.6%), which, the Fed has pointed out, makes the economy more resilient against policy tightening and broader economic stresses.

The Fed's decision to pause in June was both praised and criticized. While some preferred getting all tightening 'out of the way' first, others felt a pause or skip was prudent to let conditions 'catch up.' This follows economist disagreement about the path of future inflation. The FOMC always has critics, and there are often cogent arguments on both sides of policy decisions. As the Fed has noted multiple times, the cumulative impact of a rate hikes is not something to disregard, and the increasing restrictiveness may not yet be fully baked into the economy, as some stresses appear with a significant lag. There may be some broader complacency about this.

Rates have only been at the 4%+ level since December, so the full brunt of those highest levels hasn't been completely felt yet (by some measures, it can take up to 1-2 years). The banking system stresses of recent quarters were a good example—considering that tighter financial conditions, including a reduction in credit availability, is indeed the point of the hiking process, not a byproduct or accident. Letting this tightness 'sink in' buys time to let inflation continue to normalize, and could circumvent the need for another ramp-up in policy down the road. Whether today's hike is the end of the cycle, or we see more, the Fed has implied we're now in the fine-tuning stage, to avoid a reversal and undesired loosening in financial conditions. Interest rates are a blunt instrument rather than a finesse tool.

Financial markets have predictably cheered falling inflation, implying it means better clarity on 'peak rates' and reduced chances of further action. The treasury yield curve remains inverted, a condition which can last for a while, and has usually been solved by recession and a lowering of short-term rates. Longer-term yields (from 5-year to 30-year) have settled around the 4.0% range, which is arguably around their 'fair value,' based on the historical relationship of inflation (assuming the 2% Fed target) plus real yield (historical average also around 2%). The days of cheap financing fueled on exceptionally low interest rates are behind us, with corporations and real estate entities having refinanced debt at manageable rate levels, buying time for themselves. As loans/bonds come due, more financing stress would be expected if interest rates remain higher for some time, but less dramatically so being spread across maturities in coming years, as opposed to a mass need for refinancing at once. At the same time, bankruptcies and bond defaults are already rising, which has added pressure to the credit environment. Similar dynamics have unfolded in the residential housing market, with homeowners holding low-rate fixed mortgages choosing to simply stay in their homes, causing normal seasonal turnover to plummet, and keeping housing inventory and affordability well lower than average.

Every stage in the Fed policy cycle has winners and losers. The objective is to keep the ship somewhat steady through any potential inflationary and recessionary storms without it capsizing. So far, so good.

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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]International Monetary Fund (https://www.imf.org/en/Publications/WEO/Issues/2023/07/10/world-economic-outlook-update-july-2023)
[4]U.S. Bureau of Labor Statistics (https://www.bls.gov/cpi/, https://www.bls.gov/ppi/)