Commentary on the Fed

Disciplined Risk Management

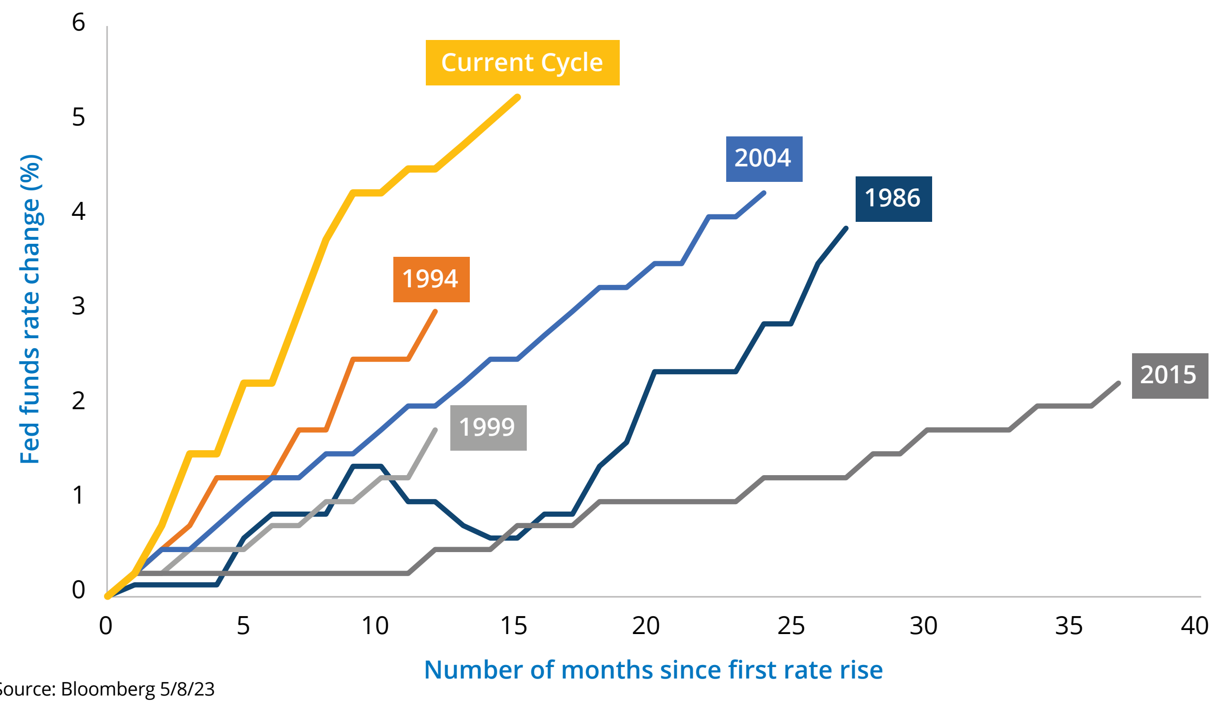
End of an Era?

May's Federal Open Market Committee (FOMC) meeting had special significance, not because of the uncertainty around what action the Fed might take in terms of rate hikes, but rather because of the guidance it was expected to offer about its plans for future hikes. More specifically, investors were eagerly awaiting confirmation the Fed intended to halt its most aggressive policy tightening campaign in more than four decades. Unfortunately, they may not have gotten exactly what they hoped for.

Action: 25 Basis Point Hike in Fed Funds to 5.0% - 5.25%

Amid ongoing concerns about high profile bank failures and a looming debt ceiling standoff, the Fed raised its fed funds rate for the tenth time in as many meetings over the past fourteen months. Ahead of the May meeting, fed funds futures market pricing indicated a roughly 85% odds of the quarter-point move, leaving little doubt the Fed would not be deterred by the lingering uncertainty generated by either circumstance.

Justification for increasing the policy rate to the pre-global financial crisis peak remained unchanged. Inflation was still trending well above target, and labor market conditions remained too tight. While the FOMC statement proclaimed "the U.S. banking system is sound and resilient," it also acknowledged the "uncertain" economic impact of tighter credit conditions resulting from the recent banking system stress.



Source: Bloomberg 5/8/23

The Pause

As the Fed looks to manage market expectations, it often uses non-committal language as not to box itself into a corner. To that end, May's FOMC statement removed the line from the March statement that read "The Committee anticipates that some additional policy firming may be appropriate," replacing it with we'll-play-it-by-ear-from-here wording. This was largely what the market expected and consistent with the way in which the Fed has communicated it was expecting to stand down at the end of past rate-hiking cycles.

The Press Conference

Chair Powell kicked off the press conference with prepared remarks that began by addressing developments in the banking sector. Just two days removed from the second largest bank failure in US history, he repeated the "sound and resilient" description of the US banking system found in the FOMC statement. One could argue this was at least a mild mischaracterization of the current status, however, the Fed would only hurt its cause of maintaining financial stability by suggesting otherwise.

In typical form, Powell reminded his audience that the central bank believes strong labor market conditions cannot be sustained without price stability. Furthermore, he would add "inflation pressures continue to run high and the process of getting inflation back down to 2% has a long way to go."

When asked directly if the Committee's statement suggested it is prepared to pause rate increases in June, Powell responded by saying, "a decision on a pause was not made today." However, he offered some consolation by pointing out that the statement no longer suggested that the Committee anticipates future rate hikes will be appropriate.

To gain insight on how the Committee might be sizing up the need to do more at the June meeting, Powell was asked about policy reaction function going forward. He highlighted a focus on how tightening credit standards are impacting lending "to asses how that fits in with monetary policy."

Main Takeaway

While a future hike is not completely off the table, investors can be reasonably confident that the rate-aggressive hiking regime is finally in the rear-view mirror. As the Fed has taken a wait-and-see approach to the direction of future monetary policy, financial markets are banking on rate cuts later this year as evidenced by pricing in the fed funds futures market. This means the pivot watch has unofficially begun.

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