Situation analysis

March 22, 2023

Federal Reserve delivers 0.25% interest rate hike to cool inflation despite recent financial market unease

Key takeaways

- The U.S. Federal Reserve (Fed) increased interest rates by 0.25% to a range of 4.75% to 5.00% today in its ongoing attempt to cool inflation.
- Some investors questioned whether the Fed would pause or even cease its rate hiking campaign that has brought short-term interest rates from near zero last year to near 5% this year, after tumult in the banking sector in recent weeks.
- Fed guidance projects a year-end policy rate of 5.00% to 5.25%, representing no change from the March projection, implying it does not believe recent market volatility alters its priority to fight inflation.

The Fed increased its target federal funds interest rate by 0.25% to a range of 4.75% to 5.00% following the conclusion of its regularly scheduled two-day meeting. Interest rate policy represents the primary tool the Fed uses to carry out its mandates of maximum employment, stable prices and moderate long-term interest rates. Still-high inflation pressured the Fed to hike rates despite tightening financial conditions in recent weeks brought on by two bank failures in the United States and the distressed sale of Credit Suisse to UBS by Swiss authorities. While inflation has decelerated from a 40-year high of 9.1% last summer to 6.0% in February, ongoing price gains above the Fed's 2% target rate continue driving Fed tightening. Additionally, tight labor markets add to Fed concerns that inflation may remain elevated.

In addition to its mandates, the Fed must also consider financial stability in its policy calculus; continued rate hikes could place additional strain on the financial system that some consider fragile despite functioning smoothly to date. Recently, the Fed, U.S. Treasury, and Federal Deposit Insurance Corporation (FDIC) coordinated to bolster confidence in the U.S. banking system by backing the uninsured deposits of a failed bank. This action, along with coordination between the Fed and other major central banks to provide additional liquidity, may allow the Fed to continue its fight against inflation with some additional rate hikes while supporting financial market functioning.

The Fed's official statement noted "some additional policy firming may be appropriate" versus its prior statement, which noted "ongoing increases," a subtle downgrade to the likely number of additional rate hikes needed to cool inflation. Investors focused primarily on Fed Chairman Jerome Powell's comments during the ensuing press conference and the Fed's Summary of Economic Projections (SEP). The economic projections indicate Fed members downgraded their growth outlook for the next two years and kept their year-end 2023 policy rate expectation of 5.125% unchanged. Powell noted the banking system remains strong, but he does anticipate tighter lending conditions for consumers and businesses. Reduced lending activity could aid in bringing inflation lower, while dampening growth. Overall, his comments indicate flexibility for the Fed to respond to changing conditions and data.

The Fed continues to reduce its Treasury and mortgage bond holdings, which reached as much as $8.5 trillion during its attempt to suppress interest rates in response to the COVID pandemic. In addition to restraining post-pandemic bond yields and encouraging borrowing, the Fed's bond buying also converted bonds held by market participants to cash, which can support economic activity through added liquidity. Starting last year, the Fed began allowing up to $95 billion

Important disclosures provided on page 3

per month to mature, forcing investors to absorb the incremental supply. The chance remains for bond portfolio runoff to nudge bond yields higher (which move in the opposite direction of bond prices) and dampen liquidity, in turn reducing a portion of the fuel available for future economic growth. However, the U.S. Treasury spending its cash balances held at the Fed to avoid exceeding the debt ceiling may temporarily offset the liquidity drained from the financial system via Fed bond portfolio runoff. Additionally, stimulus measures focused on the banking sector may also boost liquidity in the near term, moderating some of the Fed's efforts to fight inflation.

Stock prices initially rose but finished the day lower, while bond yields fell. Initially, investors focused on Powell's comment that the committee's projections for ongoing restrictive policy "are not a decision or plan … the path for policy will adjust as appropriate to foster our maximum employment and price stability goals." Later in the press conference, Powell noted, "If we need to raise rates higher, we will," sending stocks lower. The S&P 500 finished the day down approximately 1.65%. Ten-year Treasury yields fell 0.18% to 3.43% (well below 2022 highs near 4.25%). The two-year Treasury yield fell 0.24% to near 3.92% as investors reduced their expected path of interest rates despite Fed guidance. The two-year yield remains below 2022 highs near 4.75%. Lower bond yields and interest rates reflect lower borrowing costs, which can fuel economic activity.

Monetary policy, defined as central bank interest rate target decisions, continues tightening around the globe as high food and energy prices begin spilling over into prices of other items, particularly services and wages. The European Central Bank (ECB) hiked rates by another 0.50% last week, and investors expect the Bank of England (BoE) to increase their policy rate by 0.25% later this week. Net global rate hikes (the number of central banks raising interest rates less those lowering rates) set consecutive quarterly records for magnitude and count during the first three quarters of 2022, with fourth quarter net hikes decelerating only slightly, according to U.S Bank Asset Management Group calculations. First quarter 2023 net rate hikes are tracking at half the number of fourth quarter 2022 rate hikes. We anticipate a further deceleration in the second quarter as fewer central banks hike rates and some may begin cutting rates to alleviate pressure in the capital markets. Consensus expectations indicate subdued global growth for upcoming quarters, though economists expect the global economy will narrowly avoid recession or experience only a mild contraction in activity. Recent purchasing manager surveys indicate a considerable divergence between service activity (improving and now expanding) and goods manufacturing (contracting) around the globe.

Most global stock and bond market indices are positive for the year after following a challenging 2022. Today's Federal Reserve announcement complicates the outlook; the need to tame inflation (suggesting multiple additional rate hikes) conflicts with limiting further strains on capital market activity that can stem from ongoing rate hikes. Our proprietary analysis suggests the path forward for consumer activity and corporate earnings may remain under pressure, and tighter financial conditions may exacerbate reduced consumer and business activity. We do expect capital markets to oscillate between cheering less inflationary data and reflecting concerns about potential slowdowns in consumer activity. We will keep you informed of our views as we progress forward into 2023.

As always, we value your trust and are here to help in any way we can. Please do not hesitate to let us know if we can help address your unique financial situation or be of assistance.