

## Fed keeps rates steady for second meeting in a row, remains data dependent

### Key takeaways

- The U.S. Federal Reserve held interest rates steady in a range of 5.25% to 5.50% today, maintaining elevated rates to bring inflation down.
- The Fed remains open to additional rate hikes depending on the path of inflation and reiterated the importance of evaluating incoming economic and market data.
- Interest rate markets now imply low odds of a Fed rate hike by year-end 2023 and expect around 0.75% of rate cuts in 2024, a modest divergence from the Fed's latest summary of economic projections that suggest slightly higher rates.

The Federal Reserve (Fed) held its target federal funds interest rate steady in a range of 5.25% to 5.50% following its regularly scheduled two-day meeting, as widely expected by investors and economists. However, the Fed reiterated its vigilance in bringing inflation down to its 2% target, noting they “have a long way to go,” and will evaluate incoming economic and financial data to determine future rate hike progression. The Fed primarily uses interest rate policy to carry out its maximum employment, price stability and moderate long-term interest rate mandates. Considerable policy tightening from a near-zero federal funds rate in early 2022 to 5.25% to 5.5% today has contributed to Consumer Price Inflation falling from more than 9% last summer to 3.7% as of September 2023.

With no update to the Fed's Summary of Economic Projections (or “SEP,” which it updates every other meeting), investors focused on the updated statement and Chairman Jerome Powell's press conference. The Fed's statement did not materially change, aside from noting tighter financial conditions may weigh on economic activity. This tightness primarily refers to long-term Treasury bond yield rises, which increases interest costs for consumer and business borrowers. This theme persisted into the press conference question and answer session.

Powell noted higher long-term bond yields would need to meet two conditions to qualify as tightening policy on the Fed's behalf, and thus reduce the likelihood of future rate hikes. First, the rise in long-term yields could not simply relate to expectations around Fed policy. This condition has already been met, in our view, since the relationship between policy rate expectations and long-term yields has broken down recently. Second, higher long-term Treasury yields need to be persistent. Powell noted the second condition has not yet been met; thus, the Fed does not see higher long-term bond yields as impacting their rate decisions for now. During the press conference, Powell also said the question Fed members continue to ask themselves is whether additional hikes are warranted, implying an upward bias to policy rate expectations in the near term rather than equal risk of hikes versus cuts.

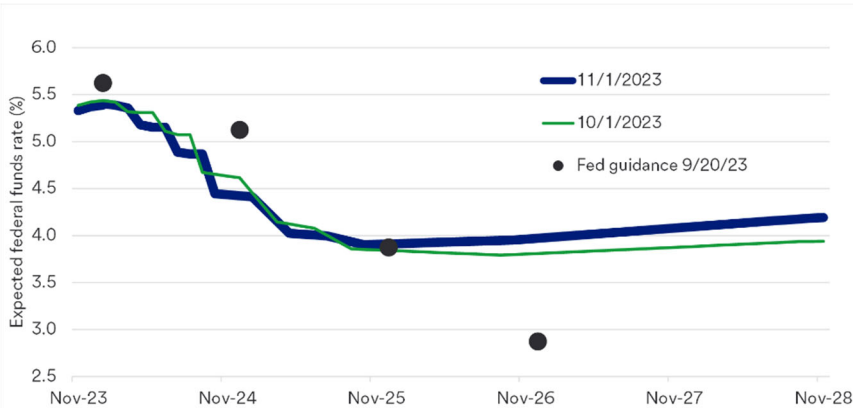
An emphasis on meeting-by-meeting decisions rather than a preset course inherently deemphasizes the Fed's rate projections. As illustrated below, the Fed's most recent projections, from its September meeting, suggest one more hike this year in December and two rate cuts in 2024. Interest rate markets now assign low odds of another hike this year and three rate cuts totaling around 0.75% next year, representing a divergence that will need to be resolved.

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Market pricing of the expected path of the federal funds rate



Source: U.S. Bank Asset Management Group Research, Bloomberg; 9/20/2023-11/1/2023

The Fed continues to reduce its Treasury and mortgage bond holdings, which reached approximately \$8.5 trillion during its attempt to reduce borrowing costs during the COVID pandemic. In addition to restraining post-pandemic bond yields to encourage borrowing, the Fed’s bond buying also converted bonds held by market participants to cash, which may support economic activity through added liquidity. Starting last year, the Fed allowed up to \$95 billion per month to mature or “run off” its balance sheet, forcing investors to absorb the incremental supply of bonds, previously purchased by the Fed. Bond portfolio runoff may 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 to finance future economic growth. Recent federal government deficit spending also necessitates a considerable increase in U.S. Treasury debt issuance, which we have seen via recent and projected issuance by the Treasury Department. This requires investors to absorb the incremental supply. These factors, along with inflation and policy rate expectations, likely contributed to the ongoing trend higher in long-term Treasury bond yields.

Stock prices rose today, having opened higher and rising further after the Fed’s statement and press conference. The S&P 500 finished the day up 1.05%, with growth-oriented U.S. stocks up the most. Treasury bond yields fell (prices rose) on a combination of less extreme issuance projections than expected from the Treasury Department earlier in the day paired with growing investor expectations that the Fed may not increase policy rates further. Ten-year Treasury yields fell 0.17% today to 4.76%, while two-year Treasury yields fell 0.13% to 4.96%.

Monetary policy, defined as central bank interest rate target decisions, remains restrictive around the globe as inflation remains uncomfortably high, although net global rate hikes have moderated recently. Expectations for additional hikes shifted from a hiking bias for the preponderance of major central banks to a more mixed picture, with some additional tightening expected by the Bank of England (BoE) and Bank of Japan (BoJ) but rate cuts from the European Central Bank (ECB).

Global stock market indices are mixed on the year, with U.S. large-company stocks — particularly those oriented to faster earnings growth — positive on the year, along with modest gains for foreign developed market stocks. However mid- and small-company stock indices and emerging market stocks have struggled year-to-date. Our proprietary trend models highlight recent price weakness across major global indices. Stock market breadth has deteriorated also, with fewer constituents participating in higher price trends than normal. Investor sentiment remains tepid compared to more robust levels in early summer. Bond market returns are challenged due to the price drag from higher yields, particularly on the more interest rate-sensitive long-term segment of the bond market. The magnitude and speed of interest rate hikes is likely to slow economic growth over time, but analysts project a corporate profit rebound in the second half of this year, and third quarter S&P 500 earnings have been solid.

We remain close to our long-term investment policy targets and await further reconciliation between some cautionary economic signals and deteriorating recent asset price trends in most major categories except for domestic large-cap equities. A deterioration in consumer and business activity under elevated interest rates coupled with declining asset price trends continue to bear watching. We will keep you informed of our views as we progress through 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.

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