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Three Takeaways from the Fed Decision

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Overview

- As we expected, the Federal Reserve (Fed) raised the fed funds rate by 0.25%, pushing the upper bound to 5.00%.
- Financial conditions were stable enough for the Federal Open Market Committee (FOMC) to release updated projections, unlike the Fed's decision back in March 2020 to delay updated projections due to financial instability.
- Yesterday, the Committee was unanimous in their decision, creating an aura of calm for markets.
- Financial stability is clearly a vital factor in future decisions, but as of now, the Fed will likely hike at least one more time at the May meeting.

- Tighter credit conditions translate into equivalent rate hikes. Therefore, the Fed can rightly soften their language that additional policy firming may (or may not) be appropriate.
- Prices in non-housing services have yet to ease and are the top concern for the Committee.
- The Fed sees Silicon Valley Bank as an outlier, not a harbinger of more banking failures. Therefore, the Fed will stay vigilant, but fighting inflation is still the main focus for monetary policy.
- Bottom Line: Investors' wishes may come true: contagion risks are low enough for the Fed to hike rates and inflation pressures are soft enough for the Fed to be near the end of the rate hiking campaign. Inflation should ease further in the latter half of this year and investors will likely be interested in taking on more market exposure in portfolios.

First, a Pause was Discussed but Eventually Dismissed

In days prior to the meeting, committee members considered pausing the rate hiking campaign due to uncertainty with some regional banks. The run on deposits at some banks in the U.S. created a bit of a scare, but as the days passed, participants believed conditions were favorable for increasing rates and markets were stable enough for participants to publish updated Summary of Economic Projections (SEP). Uncertainty in the banking sector created some division among committee members; however, the median rate forecast for 2023 was unchanged from December at 5.1%, but the path for the rest of the year is muddied. Some forecast no more rate hikes, while others forecast quite a bit more tightening.

As risks of contagion seem to diminish, investors should expect the FOMC to focus on the inflation portion of the dual Congressional mandate for price stability and full employment, i.e., the growth component of the mandate. Unlike the Great Financial Crisis, larger banks are currently well-capitalized and hedged against broader economic risks, giving the Fed room to hike rates amid the volatility.

Second, Tighter Financial Conditions are Equivalent to a Hike in Rates

The Fed may not have to raise rates as much as they expect if financial conditions tighten, since tighter conditions translate into equivalent rate hikes. Although broader financial conditions are tighter now, the Fed will likely stay vigilant with fighting inflation. Given the recent deceleration of prices across much of the economy, the Fed can rightly soften their language about future rate increases from a commitment to a possibility.

As shown in the chart below, financial stress spiked from the uncertainty in the banking sector, and will likely put a damper on the economy, and as the economy slows, consumers pull back spending, and aggregate demand falls,

the Fed may not have to hike as much as they anticipated just a few weeks ago.

View enlarged chart

Third, Fed Officials do not Expect to Cut Rates this Year.

The markets are at odds with Chairman Powell and his colleagues. The FOMC does not plan on cutting rates this year, but the markets seem convinced the committee will indeed cut rates. Who is right? The markets are probably right because the impact of tighter financial conditions, softening consumer demand, and a slowing economy will release some of the inflationary pressure. Our view is that inflation will be in the mid- to upper-3% range by end of year and will likely slow further next year.

Inflation fighting is still the Fed's main focus and therefore, it behooves the committee not to pencil in any rate cuts at this point of the cycle. But both markets and the FOMC can agree on at least one thing—the outlook for inflation the rest of the year looks promising.

Supporting the "higher for longer" view is that the banking failure of Silicon Valley Bank seems to be contained and the general financial system appears stable. Although we expect a final 0.25% increase in the Fed's target rate at the next meeting, the economy is weakening so conditions look like our baseline forecast this year will come to fruition. That is, the Fed pauses by the summertime and the economy ekes out slightly positive growth for 2023.

What Does It Mean for You?

Policy makers view the banking sector as sound. And further, during the press conference, Chair Powell emphatically communicated that the crisis within Silicon Valley Bank was an outlier, not a harbinger of more banking failures. Contagion risks are dissipating but still, the localized crisis has tightened financial conditions and increased recession risks this year. If the economy slows, the Fed may not have to raise rates as much as they had anticipated. In the near term, markets should respond favorably to the updated outlook and the latest decision. Investors' wishes may come true—contagion risks are low enough for the Fed to hike rates and inflation pressures are soft enough for the Fed to be near the end of the rate hiking campaign. LPL Research remains cautiously constructive on equities, though gains for this year may be more back-end loaded.

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