Economic commentary from the Investment Advisory Group

Fed hikes another quarter point and remains hawkish in inflation battle

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Executive summary

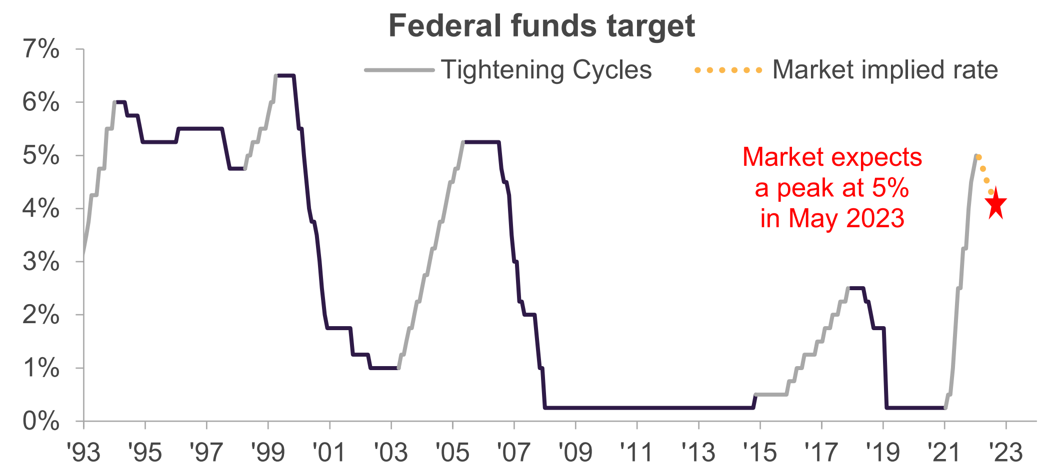
The Federal Reserve (Fed) raised interest rates by a quarter point (0.25%) as expected by markets. The Fed also left the pace of its balance sheet runoff—known as quantitative tightening (QT)—unchanged.

In the spirit of data dependence, the Fed's actions followed inflation data, which remains hotter, though clearly cooler than during mid-2022. Conversely, Chair Powell acknowledged that recent tightening of lending standards within the banking industry were like de facto rate hikes, essentially doing some of the work for them.

During the post-meeting press conference, Chair Powell threw cold water on the notion that the Fed will be cutting rates in 2023 as aggressively as markets had expected. Accordingly, stocks sold off. Meanwhile, yields fell, especially for shorter duration bonds.

A recession remains our base case as dramatically higher interest rates place additional stress on consumers and businesses going forward. We also maintain our view that, while it has clearly peaked, elevated inflation remains public enemy number one.

Markets now expect rates to peak at 5.0% in May 2023, then to fall to 4.3% by year-end '23



Sources: Truist IAG, Federal Reserve Board; market implied rate as of February 1, 2022.

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What happened

At its March rate-setting meeting, the Federal Open Market Committee (FOMC) unanimously agreed to increase its target range for the federal funds rate by a quarter point (0.25%) to a range of 4.75% to 5.00%. With today's move, the Fed has pushed the target rate up 4.75% in the past year from essentially zero.

Additionally, the FOMC released its March statement of economic projections, which sees slower economic growth next year compared to the December projections. More importantly, the so-called dot plots held expectations steady for where the federal funds rate might be by year-end 2023 but increased next year's end point.

Federal Reserve Projections

Variable	Median response			Comment
	2023	2024	2025	
Change in real gross domestic product[1]	0.4%	1.2%	1.9%	It had a modest downtick in growth expectations for 2023, but a sizable downshift in the outlook for 2024.
December projection	*0.5%*	*1.6%*	*1.8%*	
Inflation[2]	3.3%	2.5%	2.1%	Near-term inflation is clearly hotter and stickier than the prior projections.
December projection	*3.1%*	*2.5%*	*2.1%*	
Federal funds rate	5.1%	4.3%	3.1%	Held steady for the year-end 2023 expectation but increased next year's end point.
December projection	*5.1%*	*4.1%*	*3.1%*	

Data Source: Truist IAG, Bloomberg, Bureau of Labor Statistics
[1] Percent change from the fourth quarter of the previous year to the fourth quarter of the year indicated.
[2] The rate of change in the price index for personal consumption expenditures (PCE).

At the start of the post-meeting press conference, Chair Powell addressed the Fed's creation of the new Bank Term Funding Program (BTFP) less than two weeks ago. This bank backstop offers loans of up to one year to banks and other eligible depository institutions in return for U.S. Treasuries, agency debt and mortgage-backed securities, aiding in bank liquidity. That didn't quell the stream of reporter's questions about the flight of deposits from small banks, though he highlighted the safety of the banking system broadly.

Powell also reiterated that the battle against inflation has a long way to go and it'll likely be a bumpy ride. Surprisingly, he also acknowledged that the committee considered a rate pause, though the overwhelming consensus was to hike at this meeting. Moreover, he acknowledged that the tightening of credit by banks were like de facto rate hikes, essentially doing some of the work to tightening financial conditions for them. Interestingly, he said the committee didn't discuss changes to the pace of its balance sheet runoff.

Our take

Chair Powell tiptoed through quite a few thorny issues, including being dependent on backward-looking data such as unemployment. He was refreshingly frank with respect to uncertainty with their outlook, the possibility of future rate hikes or cuts later this year, etc. He also seemed to thread the needle with the respect to maintaining the Fed's flexibility to do what is necessary based on how the economy performs.

That said, we maintain our view that Fed policy is being guided by scar tissue—from prematurely loosening policy in the past. While rate cuts are plausible in the event of a sharper recession, we maintain our view that the coming economic slowdown will be relatively mild. Furthermore, inflation has clearly peaked on nearly every measure. Thus, we believe that the Fed rate tightening cycle is effectively over, though wouldn't rule out that the Fed could do one more hike rate if inflation persists.

Bond market reaction

In the days leading up to the Fed meeting, investors were split between whether the Fed would raise by 0.25% or stand pat. As we expected, the central bank prioritized its fight against inflation, moving forward with its ninth consecutive hike. However, there are notable divergences between the Fed's and market consensus' rate projections from here. Despite Fed Chair Powell's proclamation that Fed policymakers "just don't" foresee any rate cuts by the end of 2023, traders disagree. Fed funds futures suggest markets now expect the policy rate to end the year 0.50% to 0.75% below its current setting. The possibility of rate cuts this year will wholly depend on the resilience of the economy and the path of inflation. The Fed's pledge to return inflation to its 2% long-term target suggests the path to lower rates may be more gradual than the market currently expects.

In the immediate aftermath of the Fed rate decision, U.S. Treasury yields declined across the curve. The sharpest move was centered around 2- to 5-year maturities. At one point, the 2-year U.S. Treasury yield swung from its 4.25% intraday peak, dropping by more than 0.3%, but rebounded to roughly 3.95%. Yields between 10- and 30-year maturities produced a somewhat more muted reaction as the 10-year U.S. Treasury yield ended close to 3.45%, 0.16% below the start of the day.

The recent "bull steepening" move (i.e., when shorter yields fall further than longer yields) is consistent with the end of a Fed tightening cycle and rising economic risk. The lagged impact of the Fed's actions is still emerging. We also expect tighter lending and credit conditions to weigh on growth and inflation, creating downward pressure in U.S. Treasury yields. If the 10-year yield were to rise closer to 3.75%, we would view that as a tactical opportunity to add duration in fixed income portfolios that remain short of their intermediate benchmark. Lastly, we recommend an ongoing emphasis on high quality fixed income, which tends to outperform riskier fixed income sectors in slowing growth environments.

Bottom line

The Fed remains data dependent in the inflation battle. While Chair Powell maintained the Fed's flexibility to do what is necessary based on how the economy performs, we believe today may mark the end of the Fed's rate hike campaign. A recession remains our base case as dramatically higher interest rates and now tighter credit conditions place additional stress on consumers and businesses going forward.

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