Economic commentary from the Investment Advisory Group

Fed hikes another quarter point, but acknowledged a potential pause

May 3, 2023

Michael Skordeles, AIF®
Head of U.S. Economics

Chip Hughey, CFA
Managing Director, Fixed Income

Evan Moog, CFA
Fixed Income Analyst

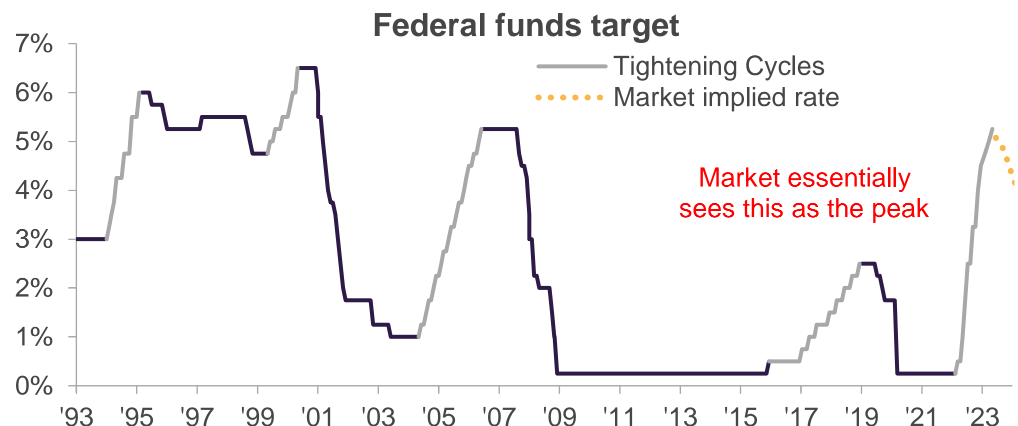
Executive summary

As markets widely expected, the Federal Reserve (Fed) raised interest rates by a quarter point (0.25%) and left the pace of its balance sheet runoff—known as quantitative tightening (QT)—unchanged. Accordingly, the market reaction was relatively muted.

While there were many considerations and the decision to hike wasn't a slam dunk, hotter inflation data compelled the Fed to move forward. 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.

Our base case is for a recession in 2023 as the lagged impact of higher interest rates and tighter credit conditions continue to weigh on the job market and the broader economy. While we believe that the Fed's rate hiking cycle is done, we can't completely rule out a June hike if inflation does not continue cooling.

Markets expects a pause then cutting rates to 4.3% by year-end '23.



Sources: Truist IAG, Federal Reserve Board; market implied rate intraday as of May 3, 2022.

What happened

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 5.00% to 5.25% at its

Past performance does not guarantee future results.

Investment and insurance products:
- Are not FDIC or any other government agency insured
- Are not bank guaranteed
- May lose value

TRUIST

Wealth

May meeting. This was the tenth consecutive meeting with a rate hike, pushing the target rate up 5% in the past 15 months from essentially zero.

During the post-meeting press conference, Chair Powell mostly played defense, parrying repeated pointed questions from the financial press. Powell was rather frank in saying that monetary policy is currently tight, meaning that its restricting economic growth. Moreover, he acknowledged that tightening credit conditions on top of quantitative tightening (QT), which increases interest rates, mimic additional rate hikes.

Our take

The Fed delivered the expected rate hike and Chair Powell managed an uneventful post-meeting press conference, not revealing any substantive changes in its thinking. We believe today will mark the end of the Fed's hiking cycle but can't completely rule out a June hike if inflation does not continue cooling. Where we disagree with the market's expectations is around the idea the Fed will cut rates multiple times this year.

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.

We foresee the Fed holding rates steady until inflation carves a consistent, clear path lower towards its 2% target. While inflation has clearly peaked on nearly every measure, we expect inflation will remain above the Fed's target at year-end. This is informed by the uptick in multiple recent inflation readings, including the core personal consumption expenditures, and the prices paid components of both the ISM manufacturing and services indices, as well as inflation expectations.

Furthermore, the full impact of what the Fed has done has not fully emerged yet. That will take many more months to unfold given the long, variable lag that comes with monetary policy changes. Hence, today's rate decision is less important than the totality of the aggressive rate hikes during the past year. We expect the Fed's rate hike campaign and quantitative tightening, coupled with tightening lending conditions, to weigh meaningfully on the economy over the remainder of this year, where we expect the start of a U.S. recession.

Coming into today, Fed funds futures trading assigned a 90% probability that the Fed would move forward with a 0.25% rate hike. This broad consensus allowed the Fed to move forward without much disruption in U.S. equity and fixed income markets. Most U.S. Treasury yields ticked lower as some traders pared future rate hike bets and participants braced for potentially slower growth following yet another rate increase. The less hawkish tone from the official Fed statement and Fed Chair Powell's press conference support our view that most U.S. Treasury yields have peaked for this cycle. U.S. Treasury yields in the 1- to 6-month range will continue to experience significant volatility until a Congress can reach a debt ceiling agreement. As the lagged impact of the Fed's tightening campaign and stricter lending standards seep into the economy more fully, we expect U.S. yields to continue declining from current levels amid a volatile trading environment.

Bottom line

The Fed largely stuck to the proverbial script, delivering the expected quarter-point rate hike. We believe today will mark the end of the Fed's hiking cycle but can't completely rule out a June hike if inflation doesn't continue cooling. 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.

Disclosures

Advisory managed account programs entail risks, including possible loss of principal and may not be suitable for all investors. Please speak to your advisor to request a firm brochure which includes program details, including risks, fees and expenses.

Truist Wealth is a name used by Truist Financial Corporation. Banking products and services, including loans, deposit accounts, trust and investment management services provided by Truist Bank, Member FDIC. Securities, brokerage accounts, insurance/annuities offered by Truist Investment Services, Inc. member FINRA, SIPC, and a licensed insurance agency where applicable. Life insurance products offered by referral to Truist Insurance Holdings, Inc. and affiliates. Investment advisory services offered by Truist Advisory Services, Inc., Sterling Capital Management, LLC, and affiliated SEC registered investment advisers. Sterling Capital Funds advised by Sterling Capital Management, LLC.

While this information is believed to be accurate, Truist Financial Corporation, including its affiliates, does not guarantee the accuracy, completeness or timeliness of, or otherwise endorse these analyses or market data.

The opinions and information contained herein have been obtained or derived from sources believed to be reliable, but Truist Financial Corporation makes no representation or guarantee as to their timeliness, accuracy or completeness or for their fitness for any particular purpose. The information contained herein does not purport to be a complete analysis of any security, company, or industry involved. This material is not to be construed as an offer to sell or a solicitation of an offer to buy any security.

Opinions and information expressed herein are subject to change without notice. TIS and/or its affiliates, including your Advisor, may have issued materials that are inconsistent with or may reach different conclusions than those represented in this commentary, and all opinions and information are believed to be reflective of judgments and opinions as of the date that material was originally published. TIS is under no obligation to ensure that other materials are brought to the attention of any recipient of this commentary.

Comments regarding tax implications are informational only. Truist and its representatives do not provide tax or legal advice. You should consult your individual tax or legal professional before taking any action that may have tax or legal consequences.

Investments involve risk and an investor may incur either profits or losses. Past performance should not be taken as an indication or guarantee of future performance.

TIS/TAS shall accept no liability for any loss arising from the use of this material, nor shall TIS/TAS treat any recipient of this material as a customer or client simply by virtue of the receipt of this material.

The information herein is for persons residing in the United States of America only and is not intended for any person in any other jurisdiction.

The information contained in this material is produced and copyrighted by Truist Financial Corporation and any unauthorized use, duplication, redistribution or disclosure is prohibited by law.

TIS/TAS's officers, employees, agents and/or affiliates may have positions in securities, options, rights, or warrants mentioned or discussed in this material.

© 2023 Truist Financial Corporation. Truist, the Truist logo and Truist purple are service marks of Truist Financial Corporation

CN2023- 5666832.1 EXP 05-2024