Deutsche Bank
Chief Investment Office

CIO Memo

March 22, 2023

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FOMC: Where do we go from here?

Key takeaways

- The FOMC announced a further increase to the Fed Funds Rate by 25-basis points. The Committee readjusted its statement language to suggest that some "policy firming" would take place instead of ongoing rate increases.
- Market volatility in recent weeks around the banking sector has readjusted investors expectations for future Fed rate increases. Futures markets are pricing in rate cuts as soon as June 2023.
- Whilst the Federal Reserve remains committed to its dual mandate and focused on incoming data, recent market moves have increased the level of uncertainty around policy direction.

1. What happened?

Today the FOMC announced a further increase to the Fed Funds Rate by 25-basis points, moving the target range to 4.75% – 5.00%. The Fed Funds Rate is now at its highest level since 2007, following its 9th consecutive rate increase.

The Fed's statement shifted its tone around inflation, moving away from previous claims that prices had "eased somewhat" to stating that inflation levels remain "elevated". The previously highlighted conflict between Russia and Ukraine was removed in its entirety to instead focus on the U.S. financial system, reiterating recent comments regarding its resilience.

Further subtle changes to the language of the FOMC statement included a slight shift around further rate hikes with the Fed now anticipating "some additional policy firming" instead of "ongoing increases in the target range". Such a change in wording could possibly reinforce the Feds 'higher for longer' stance.

As well as the decision to raise rates, the FOMC also released its latest Summary of Economic Projections. The projections showed the terminal rate remaining at 5.1% in 2023, with a decrease in 2024 to 4.3%, up from 4.1% stated in the previous projections, and 3.1% in 2025.

Whilst the median terminal rate remained unchanged at 5.1%, there were some changes from FOMC members regarding their own policy expectations. One official seeing rates ending 2023 between 5.75% - 6.00% and three officials expecting between 5.5% - 5.75%. Further widening of the Fed 'dots' were also seen for both 2024 and 2025.

Slight revisions were seen in both growth and unemployment forecasts. It is now expected that growth will reach 0.4% for 2023, down from 0.5% previously expected for the year. Growth rates remain subdued in 2024 and 2025, reaching 1.2% and 1.9% respectively. For unemployment, forecasts were revised down to 4.5% and 4.6% for both 2023 and 2024, remaining above the longer run level of 4%. The FOMC do not expect inflation (PCE) to reach 2% until at least 2025.

During the press conference, Chairman Jerome Powell acknowledged that a possible "pause" to the rate hikes was indeed discussed given the recent volatility seen in the banking sector, but there remained a strong consensus to increase rates by 25-basis points given the continued strong data coming from both inflation and the jobs market. Powell also dismissed the idea of any potential rate cuts in 2023.

When asked about the change in statement language, Powell confirmed that "additional policy firming" would be related only to the current policy tool kit available to the Federal Reserve, specifically rate increases. Discussing the fallout from the recent banking crisis, Powell reiterated the idiosyncratic nature of one bank and its lack of robust management controls. Powell stated further his support for stronger banking supervision and broader financial regulation.

2. How did markets react?

The market reaction to the latest FOMC decision appeared to be quite muted with some positive momentum seen following Powell's comments regarding a possible "pause" in the Fed Funds Rate.

There however appeared to be some selling pressure as, speaking at the same time as Chairman Powell's press conference, U.S. Treasury Secretary Janet Yellen confirmed that her department was not considering any increase in deposit insurance in light of the recent banking sector crisis.

3. What does it mean for investors?

Given the market action over the past 10 days, it would be reasonable to suspect that for Chairman Powell and the voting members of the FOMC, there would be plenty to discuss outside the topic of inflation and a strong labor market. Concerns around the strength of the banking sector globally and potential contagion effects have investors feeling a heightened sense of concern.

Such concerns have seen markets whipsawed with bond volatility spiking to higher levels and futures pricing for the Fed Fund Rates shifting dramatically to now expect cuts as soon as next quarter. It was clear from today's statement and subsequent press conference that the FOMC have focused on finding the right balance.

The recent data releases, including February's Headline and Core CPI prints of 6.0% and 5.5% respectively, as well as the continued strength seen in the labor market data, show that inflationary pressures remain a constant for the U.S. economy. Today's decision to further raise rates acknowledges that these pressures are not fading any time soon.

What impact recent events have had on tighter financial conditions may well assist the Federal Reserve in cooling the economy, leading to the FOMC returning to the potential of "pausing" its rate hikes, even possibly as soon as next month.

The concerns around financial stability will remain for the immediate future as both the Federal Reserve and U.S. Treasury work to stabilize regional bank balance sheets as well as wider confidence in the sector. Over the longer term, such events have clearly influenced the outlook for some on the FOMC with both a wider range of expected outcomes for policy rates over the coming years as well as several changes in the Fed's statement.

The impact of the past 10 days appeared to open a wider discussion within the Fed regarding the future path of rate hikes and the unintended consequences that tighter rates has on the economy. Whilst the possibility of a rate "pause" was discussed, the latest statement and economic projections indicate that the FOMC remain steadfast in their commitment to price stability.

Glossary

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

The Fed funds rate is the interest rate at which depository institutions lend overnight to other depository institutions.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

The NASDAQ index is a market-capitalization weighted index of around 3,000 equities listed on the Nasdaq exchange.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are bonds issued by the U.S. government.

USD is the currency code for the U.S. Dollar.

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