Manulife Investment Management

Market Note

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The U.S. Federal Reserve (Fed) has raised interest rates by 25 basis points (bps) to a range of 5%-5.25%. With most leading indicators suggesting a U.S. recession and banking fragility weighing on investors' minds, it was probably the final increase of this historic rate-hike cycle. In this Market Note, Frances Donald, Global Chief Economist and Strategist, Multi-Asset Solutions Team, discusses our baseline forecast.

A "hawkish pause" signal from the Fed

The market's reaction to the rate increase was muted as the Fed met expectations of a hawkish pause, and Chair Powell did his best to say very little. The post-decision statement and press conference were consistent with our view that rate hikes are now over, but the bar to cuts is quite high. These will likely only be triggered by a material deterioration in growth.

Another 25 basis points rate hike

It was one more (last?) 25 bps hike from the Fed, even as U.S. banking system fragility worsens and recession indicators flash deep red. And while there were acknowledgements from the Fed of weakening conditions, such as "tighter credit conditions" and their "uncertain" impact on economic activity, the central bank hasn't abandoned its hawkish bias either. The statement did not remove the line stating: "Additional policy firming may be appropriate". Instead, it played with the qualifications around it by more directly saying: "In determining the extent to which additional policy firming may be appropriate, the Committee will take into account [various standard factors]".

While Chair Powell tried to emphasise that this change in language around "policy firming" was "meaningful", the statement still reads to us as a *pause* with a bias towards doing more as needed.

More importantly, combined with limited adjustments to the growth assessment, this doesn't look much like a central bank panicking about banking crises or hard landings. Indeed, you could have issued this statement three months ago, and it would have appeared appropriate then.

A Fed pause vs market cuts

Of course, the Fed is in a bind: admit there are problems, and the market will continue to ease prematurely in front of the central bank, stoking housing activity (as it has been) and inflating asset prices. And yet, appear disconnected from the risks, and you create material market tightening that further hamper financial stability.

Powell tried to toe the line by underlining that Fed policy is now "restrictive" and is aware of the lagged effects of the cumulative monetary policy already in the system. However, he also said that in his base case, it would "not be appropriate" to cut rates.

Of course, markets were not persuaded, probably because investors aren't pricing in what they believe the Fed is thinking but what they believe the Fed will be forced to do. Indeed, the modal case is that the Fed will have had to cut four times (or 100 bps) by the end of January 2024.

Data dependence: "We'll be looking at everything"

The softening of forward guidance and a move into the 'pause' territory suggests the Fed is even more data dependent than in the past. But what data exactly? Powell said: "We'll be looking at everything". Yet, throughout the press conference, two data points were mentioned that we feel are important.

First, the Fed will be watching credit availability which was already worsening before the banking system stress and is likely to become more problematic as we move forward. Credit supply is one of our strongest leading indicators for all manner of economic activity. Its declining trend over the past year is one of the main pillars of our view that a recession is coming.

Second, Chair Powell spoke about “non-housing services inflation”. He said that “demand will have to weaken” and “labour market conditions have to soften” to bring down this inflationary component.

While we ultimately think the labour side of the dual mandate will force a cut at the end of 2023 or in early 2024, if Powell is watching it as an indicator, we will be too.

Our baseline forecast for a pause through to the year-end is intact

Our baseline forecast does not include further rate hikes, although the odds of another hike in the next two meetings are much higher than the odds of a cut. Further, while we envisage the start of an easing cycle with one rate cut at the end of the year, we’re also keenly aware that the Fed may lag much longer in response to weakening growth thanks to a massive price-level shock and concerns about prematurely reigniting inflation. This matters because we’re used to recessions producing immediate and sharp rate cuts. A recession with no rate cuts isn’t our central case, but we need to consider it an alternate scenario, partly because of how painful that would be for several asset classes.

Manulife Investment Management

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