



Insigneo Weekly Dispatch

The Fed's Latest Move: A Pause, a Skip, or Simply a Bid for Flexibility?

The Federal reserve decided to leave rates unchanged this week. Why would it do so, and what does it mean?

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The Federal Reserve and the US stock markets appear to have been locked in a game of chicken for more than a year. After an unprecedented easing cycle, the Fed has raised interest rates 10 times since March of last year. However, over the same period, the S&P 500 index has risen 5% and the Nasdaq 100 Index almost 10%. Granted, the markets tend to price in forward expectations before they happen. This was evidenced by a drop of nearly 10% and 15% for the S&P 500 and Nasdaq 100 respectively between January 1, 2022, and March 1, 2022, as the market prepared for the Fed to begin raising rates. Back then, the Fed had done a pretty good job of telegraphing its intentions to begin reversing its easing cycle, and the market responded accordingly. However, this time, the Fed has been telling the market that it is not yet ready to cut rates, but the market appears incredulous, pricing in cuts since the beginning of the year.

As we know, the Federal Reserve decided to leave rates unchanged upon the conclusion of its meeting Wednesday afternoon, leaving the Fed Funds rate in the 5%-5.25% range. The market had been looking ahead for this “pause”. However, it is important that we do not confuse this pause with the indisputable end of the tightening cycle, or even worse, the beginning of another cycle of lower rates. The head of the Fed, Jerome Powell, at one point used the word “skip” rather than “pause”

when referring to the decision to leave rates unchanged, then retracted the use of this word. What could be perceived as indecision by Powell is not helping get the message through to the markets. In reality though, “skip” is probably a more appropriate word than “pause”, as Powell alluded to the possibility of two more rate hikes, not cuts, this year. He even went as far as to suggest that another hike could be coming as soon as the Fed’s next meeting in July, qualifying this meeting as “live”. In fact, 12 of the 18 policy makers at the Federal Reserve saw interest rates settling in at the 5.5%-5.75% range, again, signaling that one or two more hikes are possible. The Fed seems ready to keep moving rates higher, even if it appears that the economy is heading into recessionary territory. After Powell’s comments, bond traders meaningfully reduced their expectations for rate cuts this year. However, the stock market reacted differently, reflecting one possible scenario where traders are calling the Fed’s bluff, betting that it will have to cut rates sooner than expected to avoid a recession.

We have heard that the effects of monetary policy impact the economy with long and variable lags. Given that the current Fed cycle was put in motion under the unprecedented effects of the Covid-19 pandemic, the length and variability of the lags of the current cycle are largely unknown. Chairman Powell alluded to this point when he stated one of the main reasons for deciding to skip the rate hike in June. He stated: “The committee thought overall that it was appropriate to moderate the pace [of interest rate hikes], if only slightly. That gives us more time to make decisions. We may try to make better decisions. It allows the economy a little more

time to adapt as we make our decisions going forward.” (Jerome Powell Press Conference, Bloomberg). In effect, deciding to skip the most recent rate hike buys the Fed more time, giving it the flexibility, it needs to better assess the effects of monetary tightening on the economy.

Let’s remember that the Federal Reserve has the dual mandate of price stability and maximum employment. We continue to see that although inflation is coming down, it is doing so at a slower pace than expected, and unemployment remains stubbornly low. The Fed recently upgraded its expectations of economic strength in the country, stating that it was surprised by the resilience of the labor market. This is a double-edged sword though, as a stronger economy could mean that the Fed is optimistic about the possibility of a soft landing that could avoid recession, but it could also be the reason why the Fed is not ready to declare the end of the tightening cycle. It all comes down to what the data shows, considering those long and variable lags. It is also important to consider that the full impact of the recent turmoil in the banking industry may not have been felt yet throughout the economy. We don’t believe so, and neither does the Fed. We are not saying that we are going to have another financial crisis, but some regional banks’ balance sheets may still be susceptible to the impact of higher interest rates, and tighter credit conditions could still hinder the economy. Again, the Fed bought itself some flexibility by not raising rates on Wednesday, buying some time to allow for some of these dynamics to play out in the economy.

In a poll conducted by Bloomberg shortly after the

Fed's announcement this week, approximately 65% of respondents stated that the Fed's actions would drive the economy into a recession. At the same time, 70% of respondents stated that the Fed was not done raising rates. As a matter of fact, only 10% of respondents believed that the Fed was going to cut rates this year, with the majority saying that rates would not begin to come down until the second quarter of next year or later. **Our position has been, and continues to be, that the Fed will not lower interest rates this year unless economic conditions significantly deteriorate. Powell himself stated that rate cuts are "a couple of years out". Granted, this statement is open to change and should not be taken at face value, but we do not believe that rate cuts will happen this year.** The good news is that, as Bloomberg's poll demonstrated, most investors' expectations are starting to converge with ours. The bad news is that although we believe that rates could stay higher for longer, the stock market currently appears to be pricing in a shorter time frame of higher rates.

We are seeing several developed market central banks around the world continue to raise rates after inflation continues to remain stubbornly high. The Bank of Canada, the Bank of Australia, and as recently as yesterday, the European Central Bank, continued their tightening campaigns, the first two after having previously paused. The Bank of England is expected to raise rates again next week.

Christine Lagarde, the head of the ECB, went as far as saying that another rate hike is "very likely" at the bank's next meeting. Granted, some of the inflation pressures being felt in Europe are different than those in the United States, but some are not. For example, many home-owners on both sides of the Atlantic refinanced their mortgages at lower rates over the past few years, to an extent insulating them from the pinch of higher interest rates. Eventually though, the effects of higher rates should be felt throughout the economy.

Like we said before, monetary policy acts with long and variable lags. Whether some call the Fed's latest move a "pause" and others a "skip" the reality is that "flexibility" is the most important word, as this is what the Fed achieved for itself with its latest move.



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