

Fed Recap: The Fed Separates Monetary Policy from Financial Stability

- With respect to **monetary policy** the Fed was upbeat. Job gains have picked up in recent months and the unemployment rate has remained low.
- With respect to **financial stability** the Fed indicated that the U.S. banking system is sound and resilient, though recent developments are likely to result in tighter credit conditions.
- Powell highlighted that it is too early to say if banking events will reduce the likelihood of a soft landing.
- In all, the Fed remains committed to fighting inflation.

Jim Caron: This is Jim Caron, Co-CIO of Global Balanced and Risk Control strategies. Today I'd like to perform a postmortem on the Fed's statement where they remain unwavering on inflation but see a tightening in credit conditions. Now it's important to understand that the Fed was trying to separate **monetary policy** from **financial stability** in their statements. On the monetary policy side, the opening part of their statement was that job gains have picked up in recent months and are running at a robust pace. Over the same time the unemployment rate has remained low and inflation has eased somewhat, but remains elevated. Then in the second paragraph, they address **financial stability**. What was new here compared to their previous statement was that they said the U.S. banking system is sound and resilient, but that recent developments are likely to result in tighter credit conditions for households and businesses and will weigh on economic activity, hiring and inflation. The extent of these effects is uncertain but the committee remains attentive to inflation risks.

Again, what the Fed was trying to do was balance their monetary policy actions against their financial stability concerns. Essentially they downgraded the possibility of future rate hikes and potentially even communicated a lowering of the terminal policy rate. They said that the committee anticipates some additional policy firming may be appropriate in order to attain the stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time. Now that piece of the statement, "some additional policy firming" replaces "ongoing increases in the target range." The Fed is essentially trying to communicate to the market that some additional policy firming is a downgrade from ongoing increases in the target range, and the market clearly took that to heart.

When we look at the dot plot, they still see a 5.125% terminal policy rate, which is really just saying that they're going to hike rates one more time to a level between 5% and 5.25%. Today they hiked to 5.0% and may go to 5.25% at some point. As they said "some additional policy firming" may be appropriate, replacing "ongoing increases." But they did increase their policy forecast from 4.1% to 4.3% by the end of 2024, which means the Fed expects to hike rates to between 5 and 5.25% soon, but then by the end of 2024 expect to cut rates by 75-100 basis points.

Another takeaway was that there was no pause in quantitative tightening (QT). Yes, the Fed's balance did increase by \$300 billion from certain banks tapping the Fed window and other liquidity facilities, which is viewed as an easing by some. But they are still letting their balance sheet runoff from QT which is viewed as a tightening. The Fed is really trying to play both sides here, addressing monetary policy and financial stability.

Now, they do come up with a Summary of Economic Projections (SEP) which is a forecast they release on a quarterly basis. The essential aspect of it was a slowdown in growth and falling inflation. They lowered their expected GDP growth in 2023 to 0.4%, despite strong activity data in Q1. So they're expecting GDP growth of 0.4% in 2023, coupled with a lower unemployment rate projection of 4.5% for 2023. The level of unemployment in 2024 and 2025 would stay unchanged around 4.6%, so they're looking for 4.5% by the end of this year, whereas the unemployment rate today is 3.6%. Again, they expect the unemployment rate stay steady at 4.6% for 2024 and 2025 and that growth will be sub 1%, about 0.4% in 2023. I would say this is somewhat dovish, but not too different from what was said in the past. In terms of inflation their medium core inflation forecast was revised up for 2023 to 3.6% from 3.5% and by 2024, they expect the inflation rate to be 2.6%, and 2.1% by 2025.

Powell's statement at the press conference takes on additional significance this time around because it's his opportunity to express what the FOMC is trying to convey to markets, beyond the official statement. He is effectively telling us which parts of the policy decision the Fed is trying to emphasize. He said that the Fed remains strongly committed to bringing down inflation, saying "without price stability, the economy does not work for anyone." The Fed is signaling they are still very worried about inflation and feel the need to fight it despite the recent banking sector stresses. The main culprit here is still the tight labor markets, which is keeping inflation high, and Fed policy may remain consistent to slow the economy and reduce wage inflation, which means they need to see a higher unemployment rate. That's all part of the forecasts in their SEP. What may also be required is a period of below trend growth and for the Fed to maintain a restrictive stance for some time. In other words, keep policy rates higher for longer. All of this is boilerplate language from previous meetings.

The Fed remains focused on inflation and seemingly light on the banking crisis related details. The tightening of credit conditions may be an offset for the Fed's need to hike rates further. This is an important nuance in terms of what Powell was discussing in the press conference. He was going through his idea of keeping policy rates unchanged and higher for longer, and clearly that's going to slow growth and hopefully bring down inflation, but there's still a lot of uncertainty here and it's too soon to say. However, again, he is trying to juxtapose a tightening in credit conditions that may be coming that could offset the need to hike rates further. This is why we think the terminal policy rate has perhaps one more hike left, maybe at the next meeting, depending on prevailing economic conditions.

But Powell also said emphatically that he does not see rate cuts this year and neither does anyone else on the FOMC committee. They are still dedicated to keeping inflation at target. However, the market clearly has a different idea because the market is still pricing in rate cuts. But the Fed is consistently saying that they are not planning to do that. Powell said the banking sector crisis was not a reflection of weakness in the banking sector, but rather a mismanagement at certain and specific banks. I don't know

if he is downplaying this, but that is the way Powell is communicating this. He did indicate there was a question about commercial real estate, something very topical for many, meaning that there's a lot of commercial real estate exposure at certain banks. Could this become a problem in the future? The Fed is well aware of the concentration there but does not see this as a systemic problem.

What I got the most out of from the entire press conference was when he started to talk about financial conditions, the tightening in credit. When we measure financial conditions, we typically look at market related measures, things like interest rates, 10-year treasury yields, short-term interest rates, triple-B credit spreads and the trade-weighted value of the U.S. dollar. These are all market observable points that define financial conditions. Now what Powell said was very interesting, where “financial conditions may have tightened by more than traditional market measures would indicate.” He went on to say that market-based measures of financial conditions do not capture a “reduction in lending” from banks, and that is a critical point underscoring the ongoing uncertainty in the market. Powell is certainly paying attention to the fact that there might be a tightening of lending standards, therefore less credit distributed to the real economy that might not be fully represented in market pricing at the moment. Maybe this is a hedge in terms of what he's saying, but the real point here is that he is paying attention to this. It is worth repeating, the big statement I take away from this is that “financial conditions may have tightened by more than traditional market measures.”

At the end of all of this, the Fed remained unwavering on fighting inflation, but they did acknowledge a tightening of credit conditions. Clearly the net effect of those two things has to play out over time. As Powell highlighted, it's too early to understand whether the recent banking related events will reduce the likelihood of a soft landing for the economy. Maybe he's hedging his views on that. At the meeting last month he was more emphatic about a soft landing and it seems now like he's walking that back a bit. The overriding message is that there is still a lot of uncertainty out there. In the meantime, until this uncertainty is resolved, the Fed remains committed to fight inflation, but if credit tightening is more severe than expected, the Fed will then alter its course. We are going to have to see how this plays out clearly, and it's still early days. In the end, there's still a lot of uncertainty.

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