MARKET COMMENTARY

Fed close to peak. Cuts in 2023 still ruled out despite credit squeeze

Paolo Zanghieri

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- **The FOMC members voted unanimously for another 25bps rate rise. The press release acknowledged the impact of the banking turmoil but reaffirmed the commitment to fighting inflation, whose projected path has not changed much since the Dec. meeting.**
- **The dots imply only another hike, a U-turn from the hawkish rhetoric that preceded the banking turmoil, but the FOMC still rules out cuts this year. For 2024 a flatter path of easing is foreseen compared with December. The FOMS stil sees a path for soft landing. We are less optimistic and pencil in rate cuts already in Q4.**
- **Chair Powell wanted to reassure on the state of the banking sector, but conceded that it is too early to estimate the impact of the coming credit tightening on the economy. Both an internal and an independent review will be carried out to address the supervisory flaws.**

The expected fallout from the banking sector led the Fed a with respect to the bold statements made until two weeks ago, but should not be disruptive enough- accordogn to the FOMC – to trigger rate cuts this year. The Fed expect a significant squeeze in credit standards which will work though the economy much like an interest rate increase. This has been tentatively factored in, leading to a downward revision of the growth forecast, especially for 2024. Yet, this would not be enough to bring inflation on a steeper downward path, and therefore fed funds rate will have to remain above its neutral value until 2026 at the earliest. Chair Powell was very careful to stress that the duration and depth of the credit crunch is what will matter for the impact on activity, and they are at the moment almost impossible to predict with some confidence, so the economic projections have to be taken with even more caution than usual.

The press statement devoted a lot of space to the banking woes also to reassure on the state of the overall industry and the capability of the Fed to face crises. Guidance was changed reflecting the downside risks to growth: “ongoing increases in the target range will be appropriate” was replaced by a less precise and more dovish “some additional policy firming may be appropriate”.

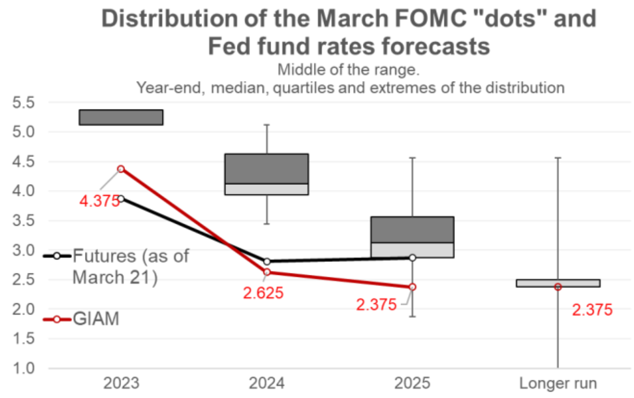
Core inflation remains too sticky: goods prices are cooling, but at a slower than expected pace. The decrease in shelter inflation is only a matter of time, but the rest of services inflation is, if anything, showing signs of acceleration. Powell repeated that disinflation is coming but the process will be slow and possibly bumpy. Taming inflation will require some softening in growth and a labour market back to balance from the current situation in which demand still vastly outpaces supply. In the projections, unemployment is expected to rise by only a percentage point from the current historical low, and, even factoring in the disruption from tighter credit conditions, the FOMC is still persuaded that a path for soft landing still exists.

Powell confirmed that just before the SVB collapse, the FOMC was in favour of rising the terminal rate based on the very strong labour market data and unwelcome inflation strength in the first readings for 2023. In the first days of the crisis FOMC members considered the possibility of a pause in rate hiking, but the overall good response of the banking sector to the measures put in place convinced them to broadly stick to the path signalled in December. Meanwhile, quantitative tightening proceeds in a "predictable and passive" manner, and the FOMC does not see the need to change the process. The recent expansion of the balance s sheet in response to the banking crisis is just meant to provide a temporary liquidity respite and will not affect long term rates (the main purpose of QE/QT).

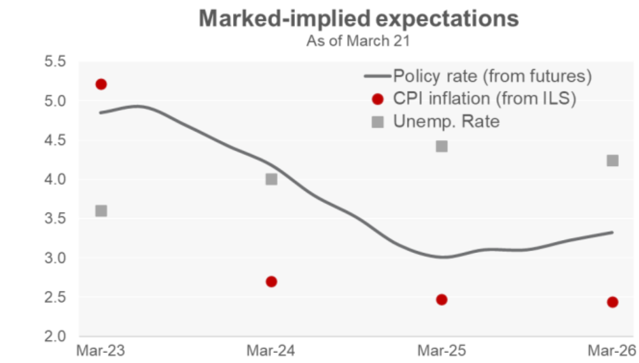
The current reading of the crisis by the FOMC is that of serious troubles affecting a limited number of very specific lenders. The measures taken are judged effective and "demonstrate that all depositors' savings are safe". This is not to be taken as an endorsement for a guarantee to all banks deposits, but as a statement that the steps taken and those that cen be deployed will be enough to maintain the public's confidence in the banking system, as shown by the reassuring dynamics of deposits in the last days. The Fed will have to learn from what happened. Powel announced an independent inquiry and an internal investigation with the ultimate goal to strengthen regulation. The overhaul will have make sure that the recommendations made by supervisors to SVB and other troubled small banks will be implemented in earnest. The Fed is aware of the risk trill lingering, especially among the smaller reginal banks and related to their heavy exposure to, for example Commercial real estate. Short term rates are a blunt tool to address them, but the Fed – reassured Powell – has an ample toolbox.

The yield on the 10-year Treasury los 20bps on the announcement, to 3.44% and the S&P was down -1.4%, as markets were probably hoping in a more lenient approach to inflation. Market continue to price rate cuts starting from this summer, based on expectations of a very quick disinflation: the implied path for unemployment is rather flat sharing the same optimism as the FOMC's one. On the contrary we expect a shallower path for disinflation but an outright recession in H2, with the unemployment rate heading to 5%. This will lead the Fed to anticipate to Q4 the first rate cuts.

	2023	**2024**	**2025**	**Longer run**
GDP growth (Q4/Q4 ann.)	0.4	1.2	1.9	1.8
Dec. projections	0.5	1.6	1.8	1.8
Unemployment rate	4.5	4.6	4.6	4
Dec. projections	4.6	4.6	4.5	4.0
PCE infl. (Q4/Q4 ann.)	3.3	2.5	2.1	2.0
Dec. projections	3.1	2.5	2.1	2.0
Core PCE infl. (Q4/Q4 ann.)	3.6	2.6	2.1	
Dec. projections	3.5	2.5	2.1	-
Appropriate path for the policy rate				
Federal funds rate	5.1	4.3	3.1	2.5
Dec. projections	5.1	4.1	3.1	2.5



Source:Federal Reserve Board, Datastream,GIAM estimates



Source:Refinitiv, GIAM

Variable	Prev. FOMC meeting	Latest	Chg.
Real Activity			
Weekly activity index (yoy GDP)	1.1	1.0	-0.1
ISM - Manuf	48.4	47.7	-0.7
ISM - Services	49.2	55.1	5.9
Macro Surprises	-10.8	52.7	63.5
Labor Market			
Payroll growth (3 mth. MA)	284	344	60
Unemp. Rate	3.5	3.6	0.1
Unemp. Rate (broad)	6.5	6.8	0.3
Hourly wages, % yoy (3 m. MA)	5.6	5.3	-0.3
Prices			
Core CPI	5.7	5.5	-0.2
Core PCE	4.6	4.6	0.0
Trimmed PCE	4.7	4.6	-0.1
U. Mich 5 yr exp.	2.9	2.8	-0.1
NY Fed 3 Y exp.	2.7	2.7	0.0
5Y5Y fwd exp.	2.2	2.2	0.0
Financial Conditions			
Chicago Fed index*	-0.3	-0.2	0.1
10 yr. Treasury	3.4	3.6	0.2
- Risk neutral Component	4.2	4.1	-0.1
- Term Premium	-0.8	-0.5	0.3
Yield curve (10Y - 3m)	-1.3	-1.2	0.1
S&P 500	4119	4003	-2.8%
Trade Wighted Dollar	126.4	128.8	1.9%
WTI Crude Oil	76.4	69.6	-9.0%
* Decrease: looser conditions			