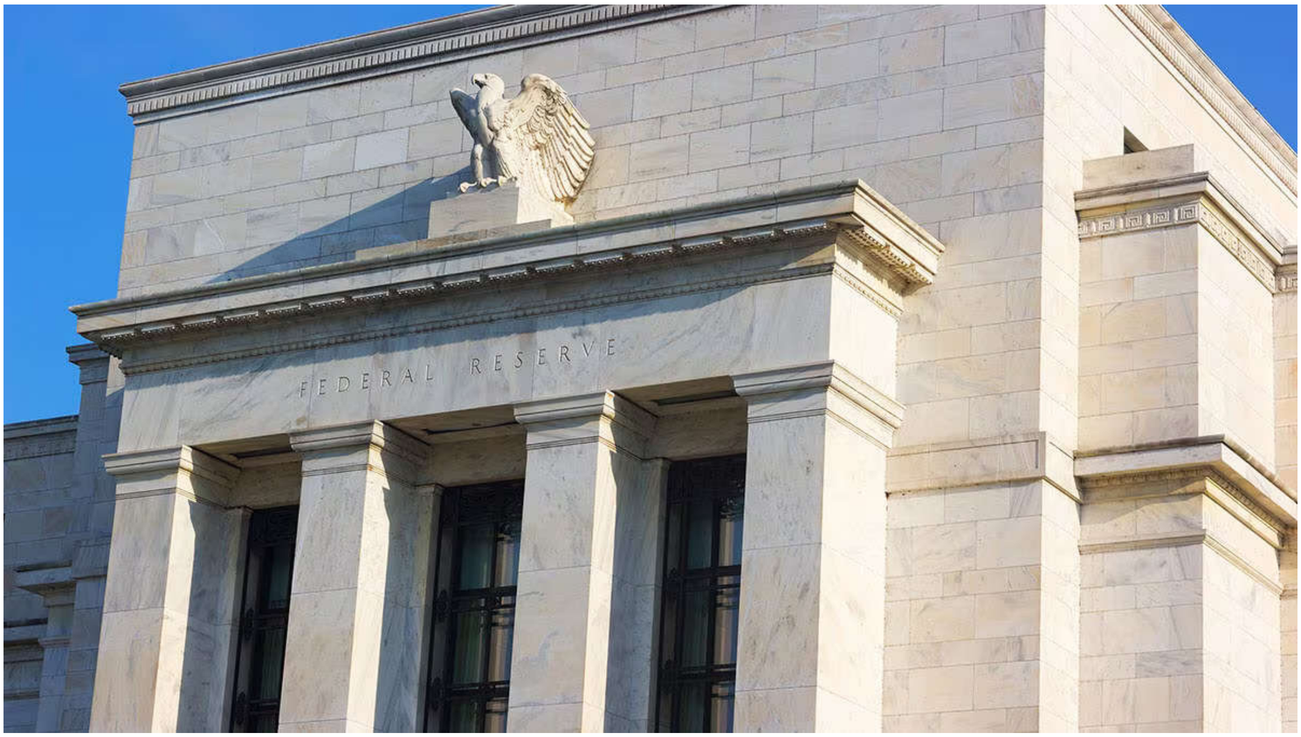
APRIL 28, 2023

Fed Preview: The End is Near

The Fed is likely to lay the groundwork for a pause, and push back against an early pivot.



The Federal Open Market Committee (FOMC) will gather next week to take stock of monetary policy. The meeting will likely mark a turning point, and so we are devoting this issue to an in-depth preview of the discussions.

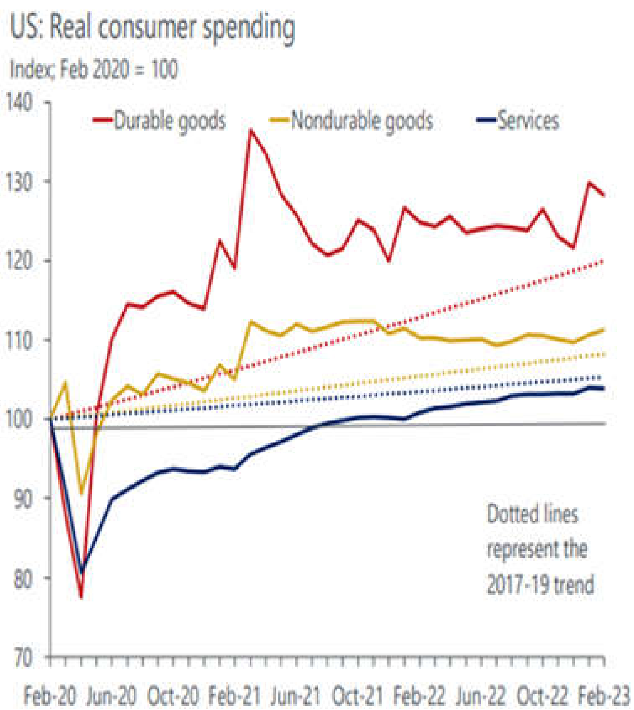
Public statements from some Fed officials suggest that stress in the banking sector justifies pausing the tightening program. Other participants have sustained a laser-like focus on inflation, which remains above desired levels. Arriving at a sound diagnosis and issuing the correct prescription will be especially challenging.

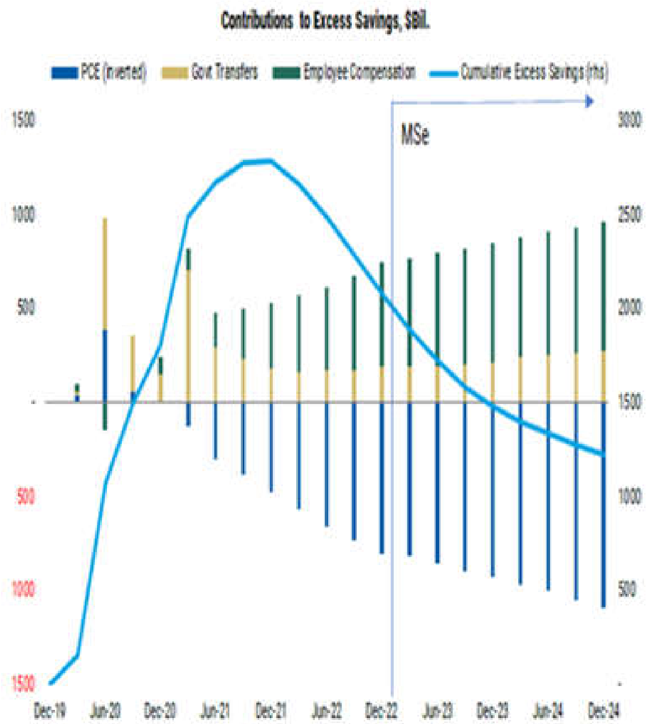
Following are the factors the group will consider, with arguments on both sides of each topic.

Economic Growth

Hike	Pause
Growth cooled in the first quarter of 2023, after a robust expansion in the fourth quarter. But the core of the economy is stronger than	Leading indicators are pointing to a weaker economy in the coming quarters. Real incomes have not

the headline print indicates. Growth was dragged down by inventories, but consumption grew at its fastest pace since 2021. Low unemployment and rising wages are supporting spending. Even if additional restraint causes a mild recession, the Fed might be willing to pay that cost to prevent wages and prices from spiraling out of control.	been growing, and pandemic saving has been reduced. The housing market is struggling under the weight of higher interest rates. Fiscal and monetary policies are providing headwinds after two years of COVID-related support. Pressing ahead with a hike could produce a deeper-than-necessary downturn.





Sources: Oxford Economics, Haver Analytics, Morgan Stanley

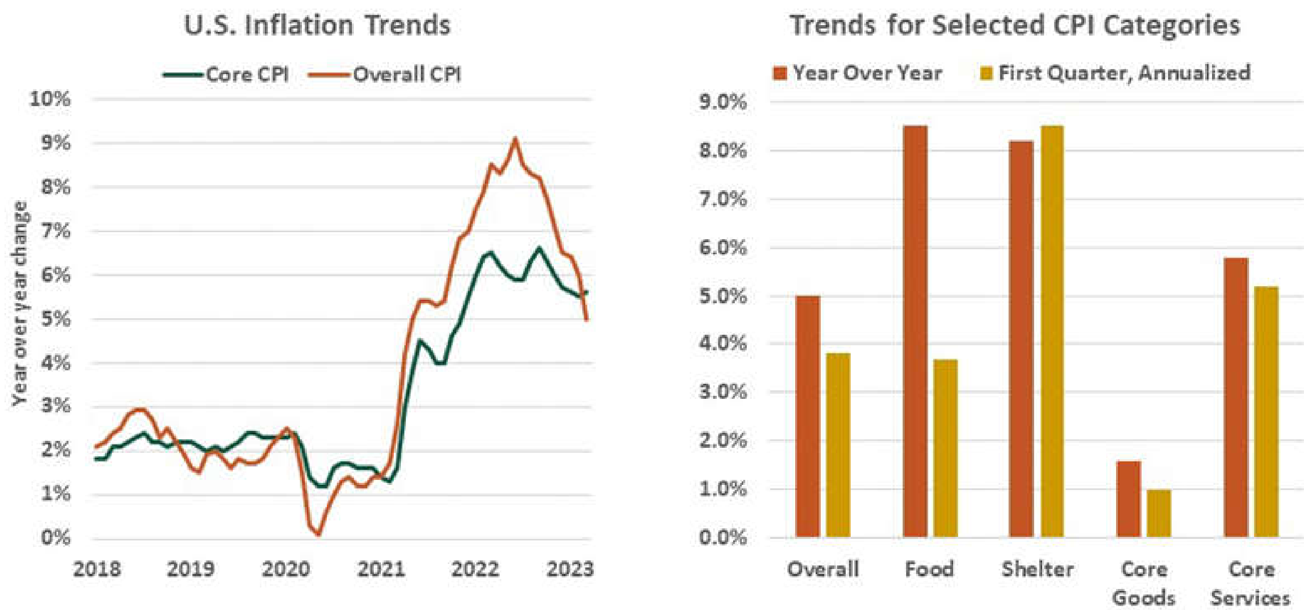
Following a strong rebound in 2021, the U.S. economy slowed last year in the face of elevated inflation, higher interest rates, weaker investment and disruptions caused by the Ukraine war. Growth is set to **slow to a crawl**, but enough to avoid the label of recession. Tighter monetary policy has impaired growth, but the expansion still has room to run. The U.S. economy has been surprisingly resilient. After real gross domestic product (GDP) declined during the first half of 2022, output has expanded at a 2.3% annualized rate since then. Absent new shocks, recession is still not our base case.

Inflation

Hike	Pause
Much of the recent improvement in headline inflation has been from normalizing food and energy prices. Core inflation (excluding food	Coming from a peak of over 9% headline inflation last year, the improvement in prices has been significant. Inflation was pushed

and energy) is holding firm, far from the 2% target. A resurgence in inflation would be damaging to inflation expectations and may prove difficult to tame. A prolonged interval of high inflation could do more economic harm than a cyclical recession.	higher first by supply chain challenges, then by the Ukraine invasion, idiosyncratic stories that are not likely to recur. The runup in house prices has ended, and will help to tame inflation in the balance of the year. The antidote for the inflation that remains is time.

As inflation shifted from a transitory phenomenon related to the COVID reopening to a systemic challenge, the Fed changed its posture assertively. The Fed Funds target rate rose by nearly five percentage points in the span of a year, and quantitative tightening was initiated. Nonetheless, inflation persisted.



Sources: BLS, Haver Analytics

Rates of price changes are on the way down, with movements over the most recent quarter quite a bit lower than the year-over-year changes. The decline in the money supply will be structurally disinflationary; cooling demand and recovering supply will also take the edge off the price level. But how far down will inflation go, and how long will it take to get there?

Inflation is heading down, but its ultimate destination remains unclear.

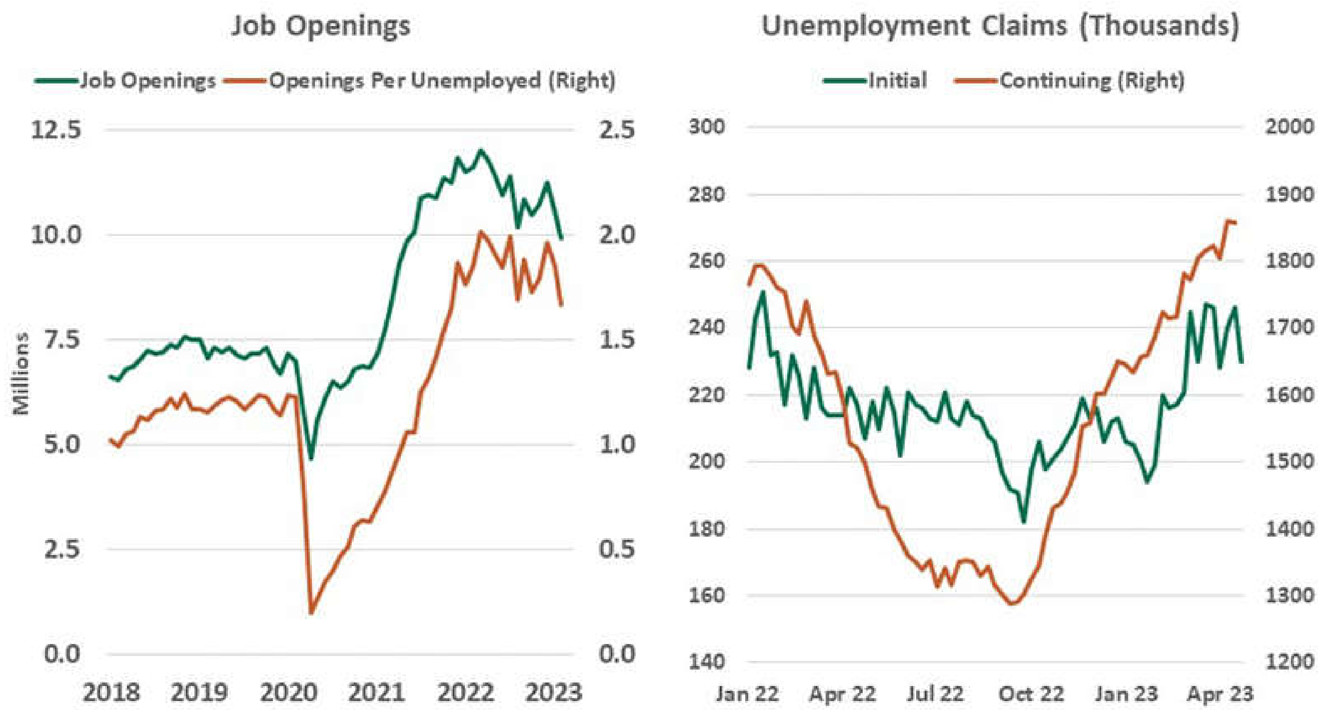
Uncertainty around the answers to those questions will make it difficult to conclude the tightening cycle. The mistakes of the 1970s, when policy was eased prematurely, are ones that the Fed does not want to repeat.

Employment

Hike	Pause
We have 3.5% unemployment, record numbers of people working, wages growing by	The latest readings on unemployment claims and job openings suggest the peak of the

more than 4% annually and the prime-age labor force participation rate back to its January 2020 peak. All signs of tremendous strength in labor markets. While job openings and turnover rates are down from their peaks, they remain well above steady-state levels. The prices of services, driven predominantly by labor costs, continue to rise at a brisk pace.	labor market frenzy has ended. Monthly job creation has been tapering off. Wage gains are moderating, while rates and quits and hires are normalizing. Renewed immigration is helping with labor supply, especially in areas where shortages have been most problematic. Balance between labor supply and labor demand is being re-established.

The job market has very likely turned a corner. The story extends beyond the conventional data we usually study; the first quarter was marked with a spate of layoff announcements from a slate of high-profile employers. The absolute numbers of layoffs have been small, but the enthusiasm in the job market has subsided.



Sources: BLS, Department of Labor, Haver Analytics

The labor market is cooler, but still hot.

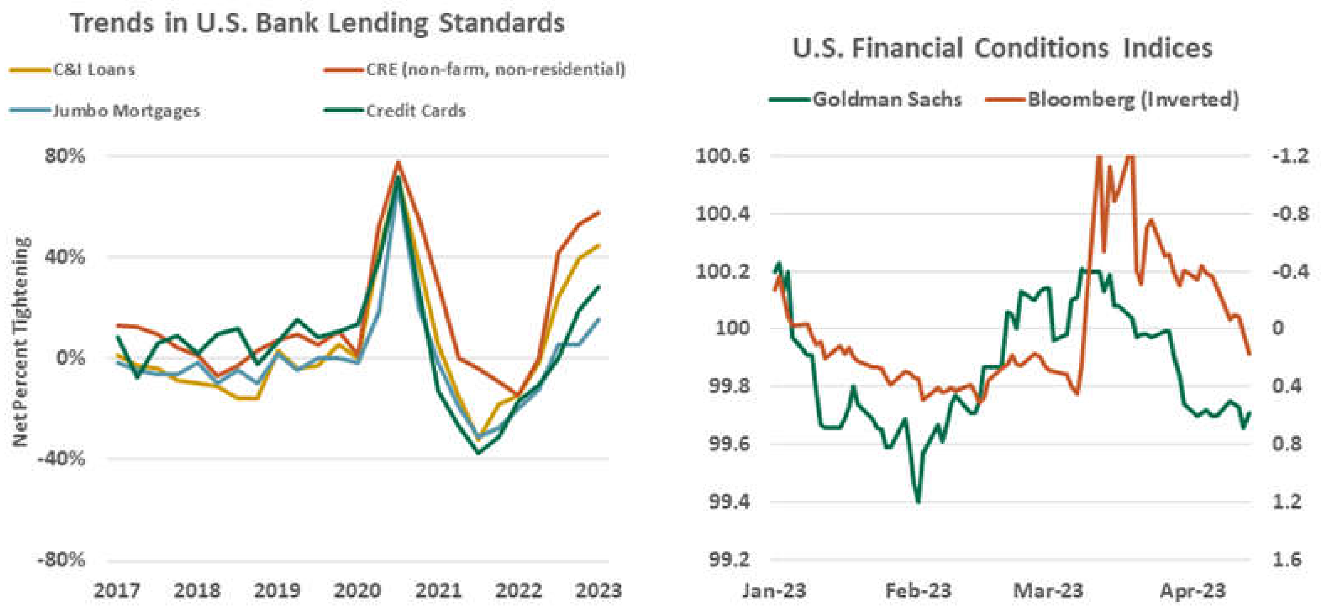
But if labor markets are the canary in the coal mine of a pending recession, this bird is still alive and well. Some further moderation will likely be needed for the Fed to head to the sidelines.

Financial Conditions

Hike	Pause
After the stress of SVB, the atmosphere around the banking industry has calmed.	Is the banking sector completely out of the woods? Last year's rapid increase in interest

Lending standards were tight and loan demand was soft prior to the events of March, so incremental tightening of underwriting may not have a big impact on credit availability. Furthermore, the United States gets almost 70% of its capital from markets; in that arena, conditions are actually on the easy side of neutral.	rates was a root cause of SVB's failure; can we be certain that others have similar problems that remain latent? Would you want to increase the risk of systemic problems from this source by increasing rates further? Small firms which use small banks are certain to feel an additional pinch, which may be enough to tip a few of them over. Better to proceed with extreme caution.

This week's headlines surrounding First Republic Bank are not pleasant, but the bank has been teetering for almost two months. Its travails have not yet spread to others; first quarter earnings reports for banks have provided no smoking guns. This isn't to say that the industry isn't still under a microscope, but the threats it presented six weeks have receded.



Sources: Federal Reserve, Bloomberg

Late last year, the Fed was concerned at the easing of financial conditions, and suggested that they might have to be more restrictive in compensation. That point is sure to be raised next week; for some FOMC participants, the idea that markets are easing will make it easier for them tighten.

Taking all of this onboard, **we expect the Federal Reserve to raise overnight rates by a quarter-point next week.** To acknowledge the deceleration of inflation and lingering anxiety about the financial system, the message accompanying the move will likely be somewhat dovish.

Bank lending conditions are tight, but financial conditions in markets are easy.

But the language will probably also discourage markets from assuming cuts later on this year. This may not go down well, as bond prices presently imply 75 basis points of retreat between now and December. We saw something similar in February; two year yields increased by almost 100 basis points in the month following tough messaging from the Fed. The FOMC will not release any new projections at this upcoming meeting, so incremental information will largely come from the press conference. In addition to the traditional topics, Chairman Jay Powell will almost certainly be asked about the debt ceiling debacle and its impact on monetary policy. We'll be leaning forward in our seats for the answer to that question.

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