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Markets And Economy

Pause? Fed Hikes, But Leaves Door Ajar for More

May 3, 2023 Liz Ann Sonders

With unanimity, the Federal Open Market Committee raised the fed funds rate by 25 basis points in May and signaled that further tightening will depend on various economic factors.

As expected, the Federal Open Market Committee (FOMC) raised the fed funds rate by 25 basis points to a range of 5.0-5.25%, with unanimity. Heading into the announcement, the market was pricing in an 88% chance of a hike per the CME FedWatch Tool. The accompanying statement did suggest this **might** be the final rate hike in this cycle by omitting prior language that had signaled more hikes ahead.

Instead, the FOMC will take into account various factors "in determining the extent to which additional policy firming may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy." As my colleague Kathy Jones, our Chief Fixed Income Strategist, put in a note, "the bar seems pretty high for additional rate hikes, where the previous statement said additional tightening was likely."

Pre-GFC rates…at long last

This move caps off the most aggressive tightening cycle in four decades and puts the fed funds rate, at long last, back to the level it was before the global financial crisis (GFC). As a reminder, the fed funds rate was near zero early last year. With a look ahead: "Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The committee remains highly attentive to inflation risks." In other words, they are trying to express optionality. That is undoubtedly, in part, driven by what has been strength in the labor market. Of note was the change in the statement now describing job growth as "robust" rather than having "picked up."

The aggressiveness of this cycle, with the Fed fighting a four decade high in inflation, has put increasing pressure on the banking system, with three of the four largest bank failures occurring just in the past couple of months (Washington Mutual maintains the top spot from the GFC era). The emergency funding facility the Fed put in place following the failure of Silicon Valley Bank in March initially eased some strains, but with the more recent (and larger) failure of First

Republic, those strains have re-emerged. Trying to quell burgeoning concerns, the FOMC statement reiterated that "the U.S. banking system is sound and resilient."

Disconnect: a pause is not a pivot

In the immediate aftermath of today's announcement, the CME FedWatch Tool was pricing in a 91% chance of no hike at the next FOMC meeting in June. The market continues to price in a couple of rate **cuts** by the end of this year—clearly not what the Federal Reserve has been communicating. This is a disconnect that needs to be resolved.

Our view continues to be that the green light for the Fed to not just pause, but to **pivot** to rate cuts would necessitate much weaker economic growth (specifically hitting the labor market) and/or more significant/pervasive/contagious stress in the banking system. With inflation still well above the Fed's 2% target, there is not yet justification for considering rate cuts in short order. The Fed is already suffering a credibility problem—a pivot to rate cuts with inflation still well above their target, and in the absence of significant deterioration in its other mandate (employment), would really damage what remains of their inflation-fighting cred.

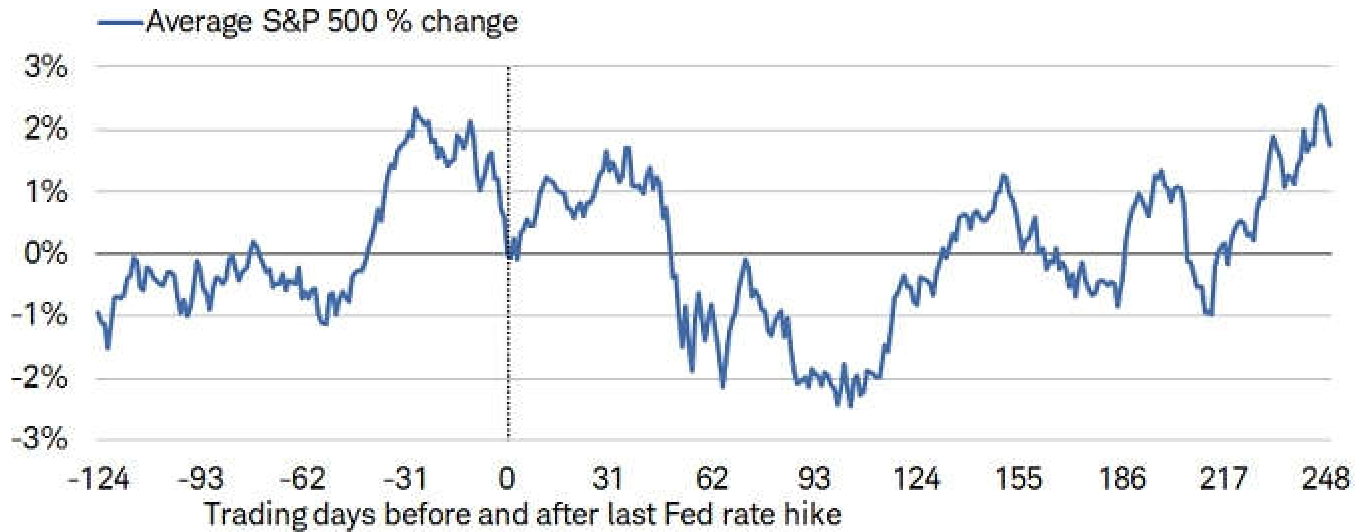
Market behavior anything but "typical"

We've been increasingly fielding questions about market behavior following the end of Fed tightening cycles. Be mindful of the fact that although there is an "average" associated with how the S&P 500 has performed, the relatively small historical sample size (14) of major rate-hiking cycles, and the ample range of prior outcomes, suggests caution around thinking there is a consistent pattern to apply to investment decision making. The first chart below does indeed show the average trajectory of the S&P 500 from six months prior to the final rate hike of each major cycle out to the following year (trading days are noted, not calendar days).

Focusing only on the average would suggest a pattern of weakness leading into the final hike, some strength in the immediate aftermath of the final hike, and then a significant sell-off out to about 100 trading days following the final hike. But, take a look at the same average in the second chart below with the full range of outcomes based on the 14 cycles since the S&P 500's inception in 1928. Obviously, there has been a wide range of outcomes—generally in the range of +30% to -30% over the span of the subsequent year.

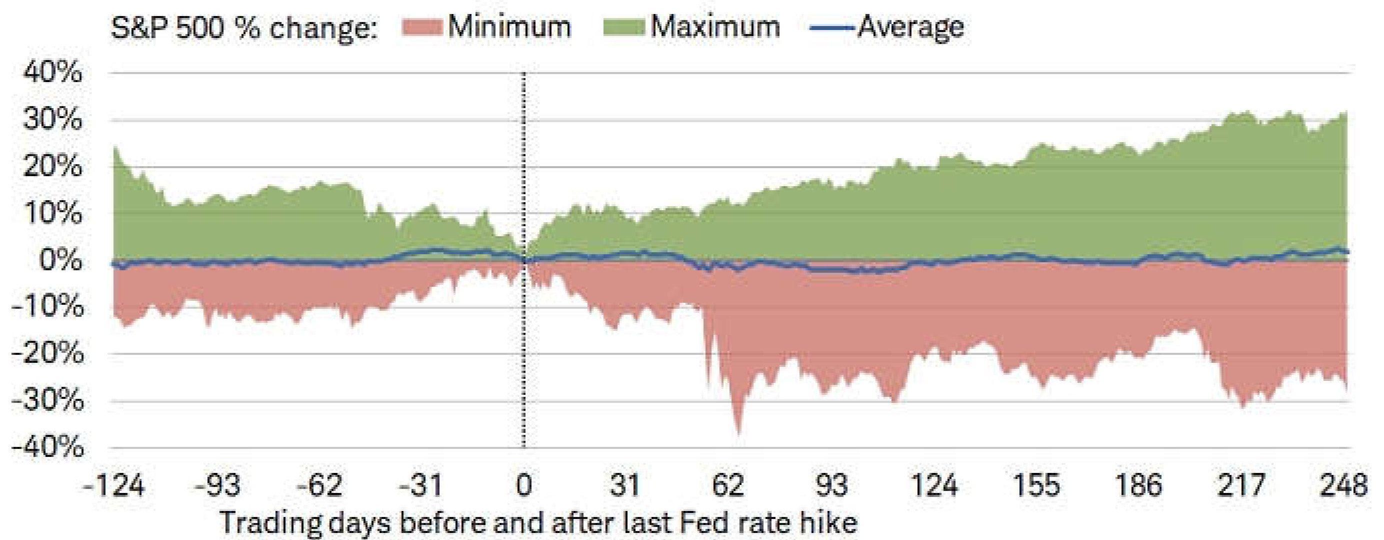
The accompanying table below details each cycle, with the date of the final hike, along with S&P 500 performance at the six-month and one-year points. Pattern? Not so much. This highlights that there are always myriad influences on market behavior—not just monetary policy. But it also reinforces one of my favorite admonitions: "Analysis of an average can lead to average analysis." While penning this commentary, I saw several headlines that flashed something along the lines of "typically, the final rate hike has been a positive for stocks"… there is no "typical" when it comes to this analysis.

What history says about final rate hikes



Source: Charles Schwab, Bloomberg, Federal Reserve, 1929-2019.

Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. **Past performance is no guarantee of future results.**



Source: Charles Schwab, Bloomberg, Federal Reserve, 1929-2019.

Green shading represents best historical performance before and after last Fed rate hike. Red shading represents worst historical performance before and after last Fed rate hike. Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. **Past performance does not guarantee future results.**

Final Fed rate hikes		
	S&P 500 performance	
Final Fed rate hike	124 days later	248 days later
8/9/1929	-17.8%	-28.6%
1/16/1953	-7.2%	-3.2%
8/23/1957	-8.2%	6.3%
9/11/1959	-5.5%	-2.8%
12/6/1965	-5.0%	-11.2%
4/3/1969	-7.4%	-10.5%
4/25/1974	-18.4%	-2.6%
2/15/1980	8.5%	11.1%
5/5/1981	-6.5%	-10.9%
2/24/1989	20.1%	14.2%
2/1/1995	19.0%	32.1%
5/16/2000	-6.8%	-15.0%
6/29/2006	12.1%	18.3%
12/19/2018	17.8%	27.3%
Average	**-0.4%**	**1.8%**

Source: Charles Schwab, Bloomberg, Federal Reserve, 1929-2019.

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Presser pressure

As usual when I pen these commentaries, in the interest of getting this published in a timely manner, the highlights bulleted below cover the first half hour or so of the press conference with Fed Chair Jerome Powell. Before getting to questions from reporters, Powell said that conditions in the banking sector "broadly improved" since early March, perhaps reflecting the early read the FOMC gets on the Senior Loan Officer Opinion Survey (SLOOS) set to be released to the public next week.

- Out of the blocks, although Powell noted the "meaningful change" in the statement's language, he said a "decision on a pause" was not made today.
- The Fed's staff continues to forecast a "mild" recession (note: it is historically rare for the FOMC's members to specifically use the "R" word); but Powell did push back on that forecast a bit.
- Powell reiterated that the debt ceiling should be raised "in a timely way" and that the consequences of default to the U.S. economy would be highly uncertain and could be "quite adverse."
- Past language was repeated that "nobody should assume" the Fed can protect the economy from the effects of a failure to raise the debt limit; but also mentioned that the risk did not impact the Fed's decision today (although they discussed the risks associated with a default).
- On the labor market, noted was the balance between labor supply and demand coming into better balance, with the prime age participation rate increasing and job vacancies falling; but Powell was clear that the "labor market is still very tight."
- When asked about the recent purchase of First Republic by JPMorgan, Powell said it was "actually a good outcome for the banking system" and that the law says the FDIC is bound to take the least-cost bid, and that he "assumes that's what happened."
- Powell said it's difficult to know how significantly tighter credit conditions would translate into the equivalent of rate hikes; and that "how long credit will be tighter is uncertain"…but that policymakers will take that into account in deciding on rates.
- As for whether the fed funds rate is now "sufficiently restrictive," Powell said it's not possible to have confidence that it's there yet and that "before we really declare that" the Fed would need to see data "accumulate."
- "Policy is tight," given it's notably above expectations of the neutral rate; while adding in the impact of quantitative tightening (QT), it suggests rates are "possibly at" a sufficiently restrictive level.
- In response to multiple questions about recession risk, Powell uttered the words that are often characterized as "dangerous": "It's possible that this time is really different."

In sum

Stocks and Treasury yields meaningfully gyrated in the immediate aftermath of the Fed's decision. Although some uncertainty may have been wrung out as it relates to the "will they, won't they" regarding a pause/end to the tightening cycle, there is plenty that remains regarding the trajectory of the economy and the ripple effect of the banking strains. We continue to believe that what we've been calling a "rolling recession" is likely to roll into an officially declared recession; especially if credit conditions tighten further. As a reminder, even before SVB fell and ignited the banking crisis, credit conditions had already tightened into recession levels.

Across both the equity and fixed income markets we continue to emphasize high quality. Specific to the equity side, we maintain our bias toward factors like high interest coverage, low volatility, strong balance sheet, healthy free cash flow, positive earnings revisions/surprises, and pricing power.