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Fed sets the stage for a pause

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As widely expected, the Fed opted to hike by a further quarter point, but also avoided saying that they had reached a judgement that further hikes might be required, with Powell suggesting in the press conference that the committee would remain data dependent. Powell pointed to the softening in interest-sensitive segments of the economy, namely housing and business investment, and the cooling in the labor market, with job openings falling, wages softening, and prime-age (25-54 years) participation increasing recently.

While the labor market is still tight and inflation is elevated, the trend towards a cooling was enough for the wording in the statement to be changed to say that the committee would now monitor incoming information to decide whether more rate hikes are in fact needed. That suggests that policymakers could be on hold for a while, as there would need to be some elapsed time before they would be able to make such a judgement, as long as the data aren't overwhelmingly leaning towards stronger than expected growth and inflation.

Banking sector issues have worked to lower the terminal rate of interest, as Powell acknowledged that policymakers don't yet know how persistent or large the impact of credit tightening due to banking sector issues would be. The banking system is still described as “sound”, with Powell pointing to the fading of banking sector issues since March, although they have added to tighter credit conditions, which will weigh on growth and inflation, but to an uncertain degree.

This is a hawkish pause, as the committee says it will be looking for signals on the need for additional firming, rather than a balanced statement that would have referenced potential moves in either direction. Similarly, the statement highlighted that policymakers are “highly attentive” to inflation risks, with no similar statement on recession risks. When asked about recession risks, Powell said that it was his view that the economy would still see modest growth over the rest of the year, and he therefore does not foresee a recession.

But if, as we expect, Q2 sees little or no growth, and inflation signals continue to moderate, the May hike should prove to be the last for this cycle, with the first easing not likely until 2024, as we'll also need time for inflation pressures to sufficiently abate. Two-year yields are modestly lower as we write relative to just ahead of the statement, with the market ignoring the slight hawkish bias and retaining the view, which we don't share, that we'll see rate cuts before the end of the year.