Economics

ECONOMIC FLASH!

economics.cibccm.com

March 22, 2023

Fed decides to walk and chew gum at the same time

by **Avery Shenfeld** avery.shenfeld@cibc.com and **Katherine Judge** katherine.judge@cibc.com

The Fed decided that it could indeed walk and chew gum at the same time, pressing on with a quarter point rate hike to quell inflation, and clearly relying on its lending facilities to address concerns over financial system stability. The rate hike was a unanimous vote, but still reflected a view that banking issues are a new drag on growth and lending activity, since the committee was clearly aiming at a 50 basis point move before the news broke about regional banks. Powell said just as much at the press conference.

Still, judging by their actions today, the base case among FOMC members that developments at regional banks might end up being the equivalent of only a quarter point rate hike in terms of the drag on activity ahead, while conceding that there is uncertainty around such impacts. So the tightening in lending capacity and standards wiped off what would have been an acceleration in rate hikes in the wake of some stronger than expected inflation data.

The accompanying forecast shows a median forecast that includes a further quarter point hike this year, and in the biggest diversion with market chatter, doesn't show a cut until 2024, with the median end of year forecast for that year, at 4.3%, actually slightly higher than the December projection. The Fed is no longer quite so certain about any of this, given the references to the uncertainties on the spillover from financial system issues. But there were no individual dots projecting a rate cut this year.

Markets seemed to be putting a lot of emphasis on the fact that the wording on further hikes no longer refers to "ongoing increases" but a more nuanced statement that "some" further tightening "may" be appropriate. While that indeed could capture some doubts about what lies ahead, it also reflects the simple fact that rates are now a further quarter point higher, leaving less to go towards a peak that isn't that much higher. Indeed, if the "dot" forecast is on the mark, there's only a single further move, and so a reference to ongoing hikes, which implied more than one, was now no longer appropriate.

Growth forecasts were only slightly lower, with the inflation outlook a hair higher. So the Fed's messaging is that they can offset the negative growth hit from financial system issues by perhaps being slightly less aggressive with hikes, but also by using their liquidity tools to keep the banking system "sound and resilient", which is how the statement characterized its current state. At the press conference, Powell reiterated his confidence in the financial system, described the steps take to stabilize it as "powerful", and indicated that deposit flight was abating.

Market participants can choose hold onto their hopes for rate cuts this year for a while, on the grounds that the Fed's hiking forecasts have, at the end of a tightening cycle, often showed further increases that didn't in fact happen. Typically, the Fed starts to show some softening of those further hikes, as they have today, before then flipping into a pause or even some cuts. But at this point, our prior forecast, which was for a quarter point hike today and a follow-up in May, seems in line with the FOMC's thinking, as well as indications that, at least for Q1, growth and hiring will still have been running too hot for the central bank's liking. So we'll stick with our view that May will see a final quarter point hike, and that rate cuts will await 2024, expecting policy makers at the Fed and the Treasury to use other tools to maintain a sufficiently liquid banking system.

The Fed also is going to walk and chew gum at the same time in terms of it balance sheet. It views QT as unwinding a QE policy that was designed to depress long term interest rates and thereby provide stimulus. Adding assets to the balance sheet at the front end of the curve, has a different objective and isn't equivalent to fresh QE.

CIBC Capital Markets – PO Box 500, 161 Bay Street, Brookfield Place, Toronto, Canada M5J 2S8 – Bloomberg @ CIBC