

Fed Recap: A Hawkish Pause, but No Mea Culpa - Inflation Still the Primary Risk

- The Fed hiked rates by 25 basis points, but seemingly signaled a “pause,” not an END, to the rate hiking cycle.
- I consider this to be “hawkish” as the Fed leaves the door open for more rate hikes if inflation does not satisfactorily fall to target, a *fuzzy* 2% as I see it.
- Powell reminded everyone of the Fed’s dual mandate, but with a clear indication that inflation is still the primary risk factor.
- When pressed about bank supervision issues Powell stated firmly that he believes the banking system is “sound and resilient.”
- In the end the question of market pricing for Fed rate cuts later this year vs. its intention to keep policy tight and achieve its 2% inflation target remains unresolved.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. I would summarize today’s Fed meeting as a “hawkish pause” with no mea culpa where inflation remains the primary risk. The Fed hiked rates by 25 basis points (bps) to a range of 5 - 5.25%, but seemingly signaled a pause, not an end. This is very important. They signaled a pause, not an end, to the rate hiking cycle and there's no dot plot at this meeting, so we don't get to peak at the FOMC member forecasts. I consider this a hawkish pause in that the Fed is leaving the door open for more rate hikes if inflation does not satisfactorily fall into their comfort zone, a fuzzy 2% target. At least that’s how I see it.

Powell's opening remarks included the standard boilerplate language that reminded everyone of their dual mandate, but emphasized fighting inflation. This means that inflation is still the primary risk factor for the Fed. Now the nuance in the Fed's language matters a lot and this is the key part of the statement that signals a pause. Let me just read a bit of it. Effectively what Powell said was that “the committee will closely monitor incoming information and assess implications for monetary policy.” Then the new part is that he said “in determining to the extent which policy firming may be appropriate.” What he left out was that the committee anticipates some additional policy changing. So he's gone to now determining the extent to which the Fed should hike rates versus where he was before that it anticipates some additional hikes. You can read through the statement yourself, but essentially those are the key words that everybody's going to key off of. He even went so far as to say that in determining the extent of future increases in the target range, meaning that he's now determining again - that word “determining” is a key part here - that they're determining if future increases in rates are appropriate.

Powell did reiterate in the Q&A during the press conference that 2% will remain firmly at the Fed's inflation target. They're not changing that which means the Fed will remain in tight policy for some time. Powell is not backing off that. It's very clear that inflation is a longer term risk for the economy even beyond the risks to smaller banks that developed over the past month or so. He was pressed on bank

supervision issues and firmly stated that he believes the banking system is “sound and resilient.” He stated that it may be different this time, another key point of the press conference, adding that what makes things different this time is that the jobs market still remains tight despite 500 bps of rate hikes, and the odds of avoiding a recession is greater than slipping into one. The difference is that typically after the Fed hikes this much, there is a sharp spike in unemployment and we slip into a recession. Powell is saying now that, well, the odds that we don't slip into recession are actually higher. That's one of the key differences that Powell continued to reiterate. Powell also addressed the potential tightening of lending standards from banks as a factor that they tighten financial conditions. In short, he intimated that it's too soon to make that assessment, but it will be closely monitored and factored into the Fed's policy reaction function.

So what are the bottom lines? Note I said “lines” because there are a couple of bottom lines here. The first one is that the question between the market pricing for the Fed to start cutting rates later this year versus the Fed's stated intention to keep policy rates sufficiently tight to achieve its 2% inflation target remains unresolved. Additionally, the Fed's policy reaction function appears to be more conditionally based on economic developments. That's what Powell is saying, that we're determining the policy in the future as opposed to what he's anticipating continuing to hike rates. This gives them really a free option to pause and keep rates unchanged at future meetings. The deck is clear for him to do that and this is what the big change is today. That said, the aggressive pricing from the bond market for rate cuts, particularly short-term, forward-rate markets, presents a risk unto itself. If a hard landing is not delivered into market expectations, the result might be that seemingly safe-haven bond positions may present a risk, which is somewhat unusual because if rates don't go down - as they're being priced to do - then that could create losses in bonds and we have to be very careful of that. Essentially this is a risk to portfolio hedges in case the economy doesn't slow down as much as people expected.

As stated before, we believe the economic and market risks are more balanced than the consensus narrative. We still like high quality Investment Grade (IG) fixed income exposure, but we prefer to synthetically create that exposure by owning some High Yield and some short duration, high-quality assets and cash, rather than just buying IG outright and taking on all the duration risk that goes along with that. We are trying to reduce the duration risk sensitivity to portfolios.

If the markets were expecting a mea culpa or a dovish statement, then there is room for disappointment, and as we like to say, it's better to be balanced and defensive and at the same time apply appropriate risk controls.

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