
A 'conditional pause' by the Fed appears to be underway

May 4, 2023



Kristina Hooper
Chief Global Market Strategist

The US Federal Reserve (Fed) hiked rates by 25 basis points in a unanimous decision today. Importantly, I believe this appears to be a de facto “conditional pause” even though Chair Jay Powell insisted “a decision on a pause was not made today.” Here’s why:

- The Fed removed this language from its statement: “the Committee anticipates that some additional policy firming may be appropriate” and replaced it with this: “the extent to which more firming is needed will depend on economic data.” That creates a very different standard for hiking rates any further.
- The Fed’s language is similar to language it used when it hit the pause button in 2006. From the August 2006 Federal Open Market Committee (FOMC) statement: “The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.”
- The Fed’s language, as well as the comments Powell made today during the press conference, is also similar to the data-dependent language the Bank of Canada (BOC) used when it announced a “conditional pause” back in January. Here’s what the BOC said at the time: “With today’s modest increase, we expect to pause rate hikes while we assess the impacts of the substantial monetary policy tightening already undertaken. To be clear, this is a conditional pause — it is conditional on economic developments evolving broadly in line with our (Monetary Policy Report) outlook. If we need to do more to get inflation to the 2% target, we will.”

In addition, the Fed has not changed its quantitative tightening policy.

Stocks fell on the news, volatility expected to rise

Stocks fell, with value stocks down more than growth stocks. The Russell 2000 Growth Index modestly rose on the day.

Gold rose, as did the VIX. US Treasury yields fell. The KBW Regional Banking Index fell again today, although it experienced a modest rebound late in the trading day.¹

We anticipate elevated market volatility in the near term as there will be even more scrutiny of the data going forward to see whether it will trigger additional rate hikes.

But the key takeaway, in my view, is that we are likely at or very near the end of the rate hike cycle. This is likely to pave the way for more supportive conditions for risk assets such as equities. Stocks, for the most part, have tended to perform well in the one to two years after rate hikes, with the exception of 2000.²

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Given our expectations for near-term volatility — exacerbated by uncertainty around Fed policy, concerns about the US hitting the debt ceiling, and fears of more issues with regional banks — I would favor defensive portfolio positioning.

However, we would anticipate an improving global risk appetite once these issues are resolved.

What are the risks we're watching out for?

There is a risk that this rate hike and continued quantitative tightening may place additional pressure on certain banks.

There is a risk that once the cumulative effects of monetary policy tightening are fully felt by the economy, they may be significant enough to cause a substantial recession.

There is also a risk that future data could suggest stubborn elevated inflation, which would likely cause the Fed to hike rates again.

It is worth noting that the tension between the risk of stubborn core inflation and the opposite risk of cumulative contractionary pressures from rate hikes and quantitative tightening may leave the Fed in a conditional pause with a neutral bias for some time. This in turn could prolong policy uncertainty and market volatility, pending greater clarity on the banking stresses and the speed and extent of disinflation.

We will be watching the regional banking situation, economic data, and inflation data closely.

With contributions from Paul Jackson, Adam Burton, Arnab Das and Brian Levitt

Reference:

Central banker quotes from the Federal Reserve and the Bank of Canada.

1. Source for performance statements in this paragraph: Bloomberg, L.P., as of May 3, 2023. Value stocks represented by the Russell 3000 Value Index. Growth stocks represented by the Russell 3000 Growth Index.
2. Sources: US Bureau of Labor Statistics and Bloomberg, L.P., as of 5/3/23, based on S&P 500 Index performance in the 1- and 2-year periods following peak inflation in February 1970, December 1974, March 1980, December 1990, and July 2008.

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