Decision time for the Fed: To pause or not to pause?

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Rate hikes pick up

Last week was a momentous one, as the Reserve Bank of Australia and the Bank of Canada both decided to hike rates after enacting conditional pauses.

Will others follow?

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What about the Fed?

I still believe the Federal Reserve will conditionally pause this week, with some stern language about continuing with rate increases if needed.

As a parent, making things conditional is a powerful tool. You can get your allowance if you do your chores. You can't go out with friends if you don't get your homework done. As the mother of a teenager, this is my personal favorite: You won't be allowed to drive the car anymore if you don't keep it clean. Our daughter's car has, at times, come to resemble a rolling garbage can, and it can be a soul-wrenching, nauseating experience to try to sift through the debris of fast food containers, athletic gear and random clothing and beauty products. (The worst part is the liquid goop in the cupholder, which seems to be the result of several different seasonal Starbucks drinks that have chemically combined with hot chocolate.) But once we laid down the law and set conditions on the use of the car, it has been quite clean (although admittedly not Felix Unger level clean).

Conditions – more specifically, conditional pauses – can be powerful tools for central banks as well. They allow central banks to take a breather and give their respective economies time to digest previous rate hikes without being viewed as dovish – which could result in a premature easing of financial conditions. Central banks recognize the dangers inherent in having a significant time lag between policy implementation and its impact on the economy. A pause can give central banks the time to analyze data and be thoughtful about policy going forward. At the same time, central banks recognize the danger of inflation becoming entrenched. Conditional pauses carry with them the power to reinstitute rate hikes if needed. They send the message that rate hikes may not be over and that central banks are being vigilant about the risks of inflation. To put it simply, they serve as proverbial swords of Damocles, hanging over markets.

Examples of conditional pauses

Two recent examples of conditional pauses are the Reserve Bank of Australia (RBA), which instituted a conditional pause in April, and the Bank of Canada (BOC), which announced its conditional pause back in January.

I thought it made sense that these pauses were conditional given the dramatic number of rate hikes in a relatively brief period of time, but also given very real concerns about the stickiness of services inflation. A conditional pause can achieve the dual goals of buying time to assess more data and continuing to control inflation and inflation expectations. As the BOC explained in January, "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."[1]

Last week was a momentous one, as the RBA and BOC both decided to hike rates after enacting conditional pauses. I found the BOC decision to hike its policy rate to 4.75%, a 22-year high, to be particularly important since Canada has been something of a first mover when it comes to monetary policy. While the RBA decision was a surprise, we knew a BOC rate hike was a very real possibility since the last Consumer Price Index print showed higher inflation than expected – Canada's first monthly increase in 10 months.

What will the Federal Reserve do next?

Last week's hikes were important because central banks' policy decisions can prove infectious, convincing other central banks to hike rates too. In fact, in its decision, the BOC made it clear that it is paying attention to what other central banks are doing: "major central banks are signalling that interest rates may have to rise further to restore price stability."[2]

I think all of this meaningfully increased the odds that the Federal Reserve (Fed) will hike rates this week, but I still believe the Fed will sit on its hands – albeit with some stern language about continuing with hikes if needed (which is being dubbed a "hawkish pause.") I'm happy to report that many of you concur with this assessment. In a poll I posted on LinkedIn last week, 55% believe the Fed will pause while 43% believe the Fed will hike at its meeting this week.

How have markets reacted?

The S&P 500 Index seemed undeterred by rate hikes in Australia and Canada, perhaps soothed by last week's US initial jobless claims, which rose for the third consecutive week, clocking in at 261,000 – well above expectations.[3] In fact, the S&P 500 entered a new bull market last week, up over 20% from its Oct. 12, 2022, low of 3577.03.[4] However, leadership has been narrow with a small number of tech stocks largely powering the rally. I think there are legs to this rally, given that FOMO (fear of missing out) is driving more investors into stocks right now, but I also believe there are potential potholes in the near term given uncertainty about Fed policy.

It's also worth noting the strong performance of Japanese stocks. Last week, the Nikkei 225 Index closed at its highest level since 1990; it is up well over 20% year-to-date.[4] The combination of Japan's post-COVID better-than-expected economic growth and still-supportive monetary policy helped fuel these gains.

It will hopefully serve as a reminder of the opportunities that exist outside the US.

Looking ahead to more central bank meetings

This will be a busy week, with significant data to be released. However, there is one data point that will be more important than any other – the US Consumer Price Index (CPI). Inflation is of course of critical concern to the Fed, and this will be the last measure before the Fed meets. Recall that in June 2022, a high CPI print right before the Fed meeting was one of the reasons the Fed chose to hike rates 75 basis points rather than the anticipated and communicated 50 basis points. I doubt a pivot like that will take place again, but in this business, I have learned to never say never.

We also have three major central bank meetings – the Fed, the European Central Bank, and the Bank of Japan all this week, and the Bank of England will be next up to bat, on June 22.

The European Central Bank (ECB) and Bank of England (BOE) are very, very likely to hike and keep signaling at least one further hike for the ECB and probably more for the BOE. Their conditional pauses will likely come later, given that they face higher inflation rates and are further behind the curve than central banks such as the BOC and the Fed. Headline inflation has been falling fast in both the UK and eurozone, but the risk is that core inflation continues to rise in both, particularly the UK.

As for the Bank of Japan (BOJ), it seems pretty clear that Governor Kazuo Ueda is not yet worried about inflation. So the BOJ seems pretty likely to stand pat. It seems unlikely it will even tweak its yield curve control policy just yet, although again I will never say never.

Thus, of all the four big upcoming central bank meetings, the Fed will be the most important because there is somewhat more uncertainty. The market is currently pricing in a relatively low chance of a hike – even less than those of you who participated in our poll. Whatever the rate decision, we are likely to get clearer indications of what is in store for monetary policy in the near term. I will be very focused on the Summary of Economic Projections for guidance on Fed members' expectations for the terminal rate as well as insight into when the Fed is likely to start cutting rates. And of course, the presser will be "must-see TV." Fed Chair Jay Powell often reveals useful information about the deliberations and calculus of the Fed. He will also likely use the opportunity to emphasize that the Fed will continue to be very conditional in its approach to monetary policy, keeping that sword of Damocles hanging over markets.

With contributions from Arnab Das

Notes

[1]Source: Bank of Canada Governor Tiff Macklem, Monetary Policy Report Press Conference Opening Statement, Jan. 25, 2023

[2]Source: Bank of Canada Statement, June 7, 2023

[3]Source: Bureau of Labor Statistics, June 7, 2023

[4]Source: Bloomberg, L.P. ,as of June 9, 2023

Important information

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

An investment cannot be made directly in an index.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

A basis point is one hundredth of a percentage point.

The Consumer Price Index (CPI) measures changes in consumer prices. Core CPI excludes food and energy prices while headline CPI includes them.

The Summary of Commentary on Current Economic Conditions by Federal Reserve District (the Beige Book) is published eight times per year. Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its district, and the Beige Book summarizes this information by district and sector.

The terminal rate is the anticipated level that the federal funds rate will reach before the Federal Reserve stops its tightening policy. The federal funds rate is the rate at which banks lend balances to each other overnight.

The S&P 500® Index is an unmanaged index considered representative of the US stock market.

The Nikkei 225 Index is a price-weighted average of 225 top-rated Japanese companies listed in the first section of the Tokyo Stock Exchange.

Monetary policy tightening is used by central banks to normalize balance sheets.

The Monetary Policy Report is a quarterly report by the Bank of Canada's Governing Council. It presents the bank's base-case projection for inflation and growth in the Canadian economy and its assessment of risks.

The Bank of Japan's yield curve control policy seeks to fix yields on 10-year Japanese government bonds around zero, tolerating moves of up to 50 basis points above or below that level.

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