Week ending 16th June 2023

Top of Mind: A pause but no pivot yet.

What's Going on Here?

Having already lifted its benchmark rate to the highest levels since 2007, the Fed has for the first time in over a year decided to hold interest rates steady with the target for its benchmark rate remaining at 5%-5.25%.

What Does This Mean?

In keeping interest rates at the current level, the Fed acknowleged that policy works with a lag and said that it wanted time to assess the impact of the hikes so far. The bank has already raised rates ten times since March 2022 as it battles to bring inflation under control. While maintaining the rate at the current level, the Fed framed it as a pause rather than a change in direction. Committee members continue to indicate that they still expect to hike further in subsequent meetings.

Federal Reserve chairman Jerome Powell said the bank was still waiting for evidence that inflation was slowing "decisively." Consumer prices rose 4% in the 12 months to May, climbing just 0.1% from a month earlier as reported by the Labor Department. That remains higher than the 2% rate the bank considers healthy while prices for items beyond food and energy continue to rise steadily. Powell added in his accompanying statement that the progress made is not suffient and said, "we're going to have to keep at it."

Why Should I Care?

We have already seen other central banks pause and then raise rates at subsequent meetings. Most notably here in Australia where the RBA again raised the cash rate at the last meeting after a pause. Canada also followed that path citing stubborn inflation pressures as they began raising rates again. The European Central Bank also raised rates at its meeting last week by 25bps to 4%.

But back to the US, Powell noted that going forward, " it may make sense for rates to move higher but at a more moderate pace". Higher borrowing costs should reduce demand for home loans, business expansions and other activity, eventually cooling the economy and easing pressures that have been pushing up prices.

Fed policymakers now expect the economy to grow 1% this year - stronger growth than anticipated in March, according to projections that accompanied the rate announcement. The unemployment rate is also forecast to be 4.1%, lower than previously estimated. The estimates also show they see less progress controlling inflation than in March.

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Mr Powell said he saw no chance that rates would come down this year. Meaning that rates are most likely going to end the year higher than they are now but how much higher still to be determined.

Portfolio Implication?

We had expected a hawkish pause from the Fed, and it delivered, signalling two more rate hikes this year. The meeting raises the risk the Fed does even more, but for now we are sticking with our view that a looming recession discourages further tightening beyond another 25-50bps. We think this downturn will trigger an easing cycle as inflation falls and unemployment rises, with a first cut pencilled in for next year.

From a portfolio positioning perspective, we believe the above scenario lends itself to adding exposure to US fixed income which we have added to our real return fund. The eventual slowdown and potential recession should see a flight to quality and bonds. The subsequent fall in yields will correspond to a bond market rally.

Key events this week:

This week it is relatively quiet in relation to local data points with the focus instead back on the RBA Minutes for June published on Tuesday.

Overseas, Fed Chair Powell gives House (Wednesday) and Senate (Thursday) testimony with focus on whether the July FOMC meeting is truly “live,” and if the Fed dot plot of two more hikes is a true base case depending on the data or more ‘aspirational.’

Across the pond, the BoE meets on Thursday where we expect a 25bps hike given very elevated inflation and wage pressures. A day before the meeting the CPI is out, which may further shape expectations.

Global PMIs on Friday will provide an important update on whether the services side of the global economy is continuing to hold up, or whether the weakness currently seen on the manufacturing side broadens.

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