TAKING STOCK: THE FED HITS A SPEEDBUMP ON THE ROAD TO MANAGING INFLATION (PART TWO)

Jennifer Appel, CFA, *Senior Investment Director, Asset Allocation*

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Investors looking for clarity around the future path of interest rates were left empty-handed on Wednesday.

In a decision complicated by still-elevated inflation levels and recent turbulence in the banking sector, the Federal Reserve voted unanimously to raise rates by 25 basis points to a range of 4.75%-5.00% and said it would continue the process of reducing its balance sheet. Looking ahead, the projections from the Fed Open Market Committee (FOMC) show a significant amount of dispersion among participants' terminal rate expectations over the long term. The lack of consensus reiterates the importance of upcoming economic data in shaping the Fed's path, given persisting inflationary pressures and the instability in the financial world.

While the Fed's rate hike was in-line with NEPC's expectations, marginal changes to the Fed's policy statement – including the notable omission of the phrase "ongoing increases" in rates will be appropriate – have muddied the outlook for the central bank's future path. This uncertainty is reflected in a sizeable divergence between the FOMC's expected policy rate of 5.1% at the end of 2023 and the market's lower expectation of 4.2%. The market continues to price in rate cuts in the back half of the year, even as Fed Chair Jerome Powell doubled down on his commitment for no rate cuts this year given the inflation backdrop.

The discrepancy underscores the shadow cast over the banking sector amid the fallout from the collapse of Silicon Valley Bank and UBS's hurried takeover of Credit Suisse. The turmoil within banks has emerged as a key data point influencing the path forward for the Fed Funds rate. While unlikely, increased distress in the banking sector, including a sustained restrictive lending environment, could magnify economic risks and put downward pressure on terminal rate projections.

At NEPC, we still believe the concerns surrounding the banking sector are temporary and will stabilize in the coming months – reinforcing our upward bias in terminal rate projections relative to the market's pricing. Barring a broad and systematic shock to the economy, we continue to believe any Fed rate cuts are unlikely in 2023.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

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