AST DEFEASANCE RATE MARKET UPDATE

RATE MARKET UPDATE: June 15, 2023 | FOMC Result; US Retail Sales

- **FOMC holds rate steady; Signals more rate hikes may be appropriate**
- **Chairman Powell rules out rate cuts in 2023**
- **Fed "Dot Plot" indicates 2 more 25 bps rate hikes possible in 2023**
- **Retail Sales data prints stronger than expected**
- **SOFR Swap Rates slightly lower this morning (~2-4 bps)**

The FOMC held rates steady, fulfilling the much anticipated "pause" that market participants were expecting. That said, the FOMC was clear in their statement and in the new dot plot that further rate hikes are likely to be necessary to vanquish inflation and return inflation to the targeted 2.00% level. Market reaction to the rate decision and Powell press conference was surprisingly muted – rates jumped around during the press conference but overall did not move significantly. Powell was actually careful to avoid committing to much of anything in the future during his press conference. While acknowledging the two additional rate hikes many of his colleagues penciled in, he repeatedly emphasized that they are only forecasts and that the evolution of the economy is uncertain. This puts the Fed squarely in "data-dependent" mode and Powell attempted to emphasize this at his press conference. "The committee thought overall that it was appropriate to moderate the pace, if only slightly," Powell said. He added: "That gives us more information to make decisions. We try to make better decisions. It allows the economy a little more time to adapt as we make our decisions going forward." FOMC members agreed and that was reflected in the post-meeting statement that was released. The FOMC said: "Holding the target range steady at this meeting allows the committee to assess additional information and its implications for monetary policy."

In summary here is where we are in terms of monetary policy:

- FOMC "hawkish pause" yesterday – overnight rate *unchanged*
- Fed moves to "data dependent" mode
- New Fed projections signal more rate hikes possible (See Chart 3)
- Revised "dot-plot" shows two more 25 bps rate hikes penciled in for 2023
- Currently the market is anticipating the next rate hike at the *September 20th* FOMC meeting
- Powell once again rules *out* rate cuts in 2023
- Next Fed meeting July 26, 2023.

CHART 1: 2Y & 3Y SOFR SWAP RATES – PRIOR 30 DAYS

The Bloomberg chart below shows 2y and 3y SOFR SWAP rates for the prior 30 days. You can see term SOFR rates have continued to move higher in anticipation of more rate hikes. 2y SOFR swap rates are up almost 50 basis points from a month ago. From here the direction of rates is uncertain and I expect volatility to remain elevated as the market tries to read the economic tea leaves and anticipate the FOMC's next move. Hawkish Fed-speak and strong economic data pushed yields higher over the last month as the market increasingly anticipated a rate hike and that was reinforced at yesterday's meeting. I expect the market will be even more sensitive to economic data as they try to interpret the impact on forward monetary policy. It is certainly possible that rates bounce around in a range – as mentioned we have seen a significant rate increase the past 30 days – a 25 bp rate hike is already built into the curve. Beyond that, should the market feel that the data warrants another 25 bp hike, rates will move higher. Dramatically weak economic data, or lower than expected inflation, will push rates lower on expectations the FOMC will be paused indefinitely.

CHART 2: US Retail Sales Show a Resilient US Consumer

The below Bloomberg chart shows Retail Sales data since August 2022. US retail sales unexpectedly rose in May, signaling resilient consumer demand in the face of mounting economic challenges. While the sales data came in stronger than expected, it still showed moderating consumer demand from last year. US consumers have kept spending despite a backdrop of elevated prices and higher interest rates, primarily supported by a still-robust US job market and pent-up savings. The retail sales data offer another slice of the demand picture for Federal Reserve officials ahead of their July 26 policy meeting. Sustainable household spending has kept price pressures from slowing appreciably, which has complicated the Fed's inflation fight and helped keep US inflation sticky.

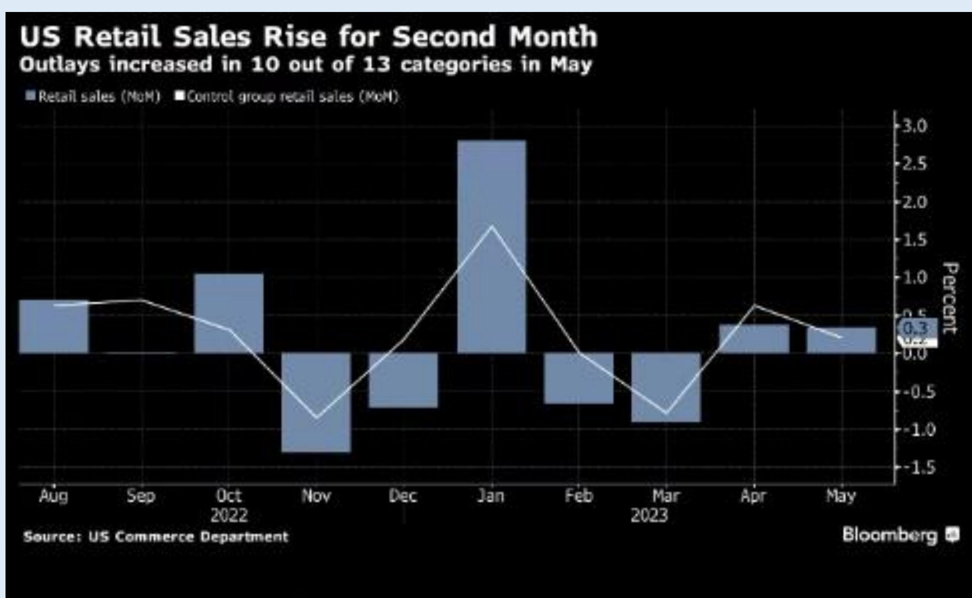


CHART 3: FOMC Projections Point to Further Rate Hikes

The FOMC updated their forward economic projections for the remainder of the year. The below Bloomberg chart details 3 of the more significant FOMC projections. GDP and inflation forecasts were revised up, whereas unemployment was revised down. The new projections signal that the Fed is still *very* worried about inflation. Stronger GDP, a robust jobs market and higher core inflation are the *last* thing the FOMC wants to see. These projections tell me that the Fed is definitely serious about raising rates further to combat inflation – the projections are meant to prepare the markets for that possibility. However, yesterday's pause gives the Fed breathing room to interpret data and see how the economy unfolds over the next couple of months. Recall also that Powell basically went out of his way yesterday to stress that these are forecasts that can change frequently. We could easily see a situation where economic data deteriorates and the Fed remains on hold for the rest of the year. There is by no means an iron-clad guarantee that the FOMC will definitely raise rates further. Keep in mind that actions by the FOMC have a lagging effect – many economists and market participants feel we have yet to see the full effects of the Fed's massive rate hiking campaign. Right now, the market has a 25 bp hike priced in by the September meeting.

Also of note, the ECB (European Central Bank) raised rates today and signaled another 25 bp hike is “very likely” for July. This is another reminder that inflation pressure exists *globally* and will continue to be a primary focus for global central banks.

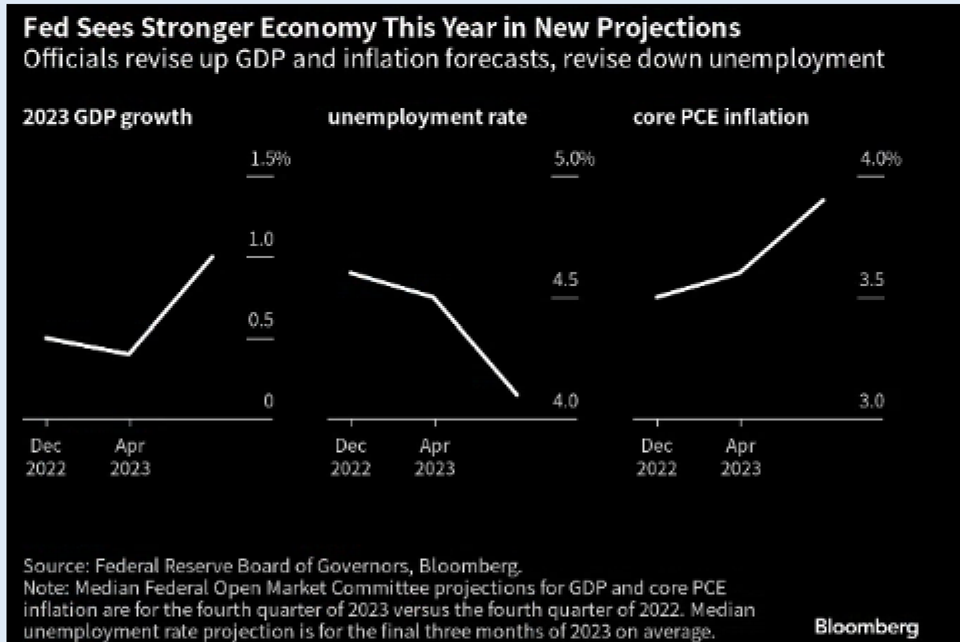
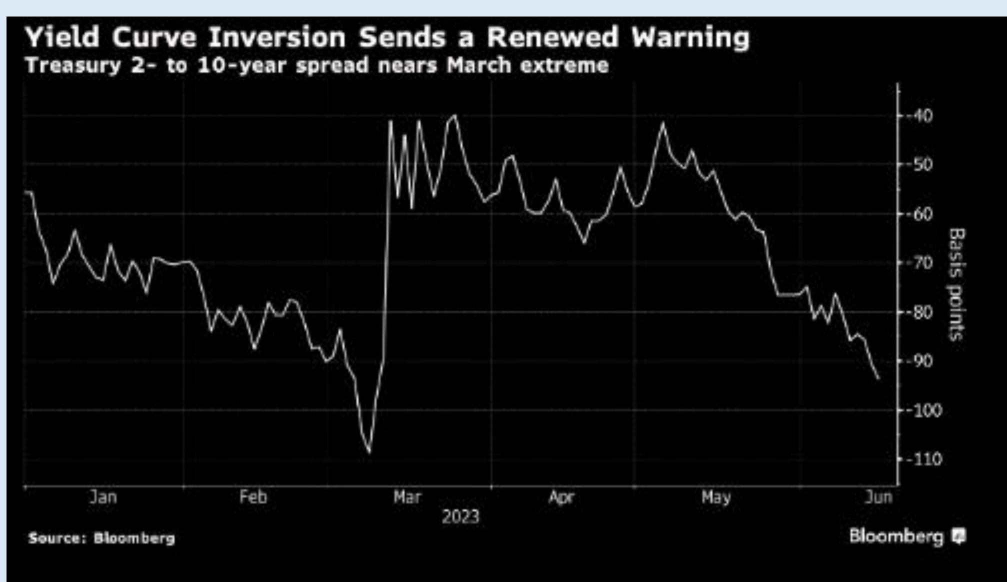


CHART 4: Yield Curve Inversion Renews Recession Fears

The Bloomberg chart below details the current Treasury curve inversion, specifically the relationship between 2y and 10y Treasuries – the inversion at the moment is ~-95 bps (10’s lower than 2’s). The highest the inversion has been since the Fed started raising rates was -109 bps, so you can clearly see the market’s fear increasing. I include this chart as a counter the case for more rate hikes. You can see from the chart that the inversion has deepened the past 45 days or so – an inverted yield curve is generally thought to be a precursor to a recession (not a *cause*, but rather a precursor) – frankly, this has been a market fear since almost day one of the Fed’s tightening campaign – so far, no recession. After some flattening in the yield curve earlier this spring, the inversion has become more pronounced again as the Fed continues to signal more rate hikes are possible. However, as mentioned there are some concerning economic crosswinds blowing that will be a key focus for the FOMC and market: Can US consumer demand hold up? Is the labor market showing cracks of weakness? Will sustained high rates crush the housing market? What about tightening credit and lending conditions? Are banks ok? Is inflation finally contained? These are the questions (and others) that the Fed will be grappling with ahead of the July and likely September meetings. As long as inflation stays in check and disinflation continues, weaker economic conditions and a slowing job market would encourage the Fed to hold rates where they are and not risk tipping the economy into a severe recession. Further rate increases may push the economy into recession and this is once again a growing market fear. So far, there has been a delicate balance between the economy and the inflation-prompted FOMC rate hikes – the Fed is keen to maintain this balance.



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