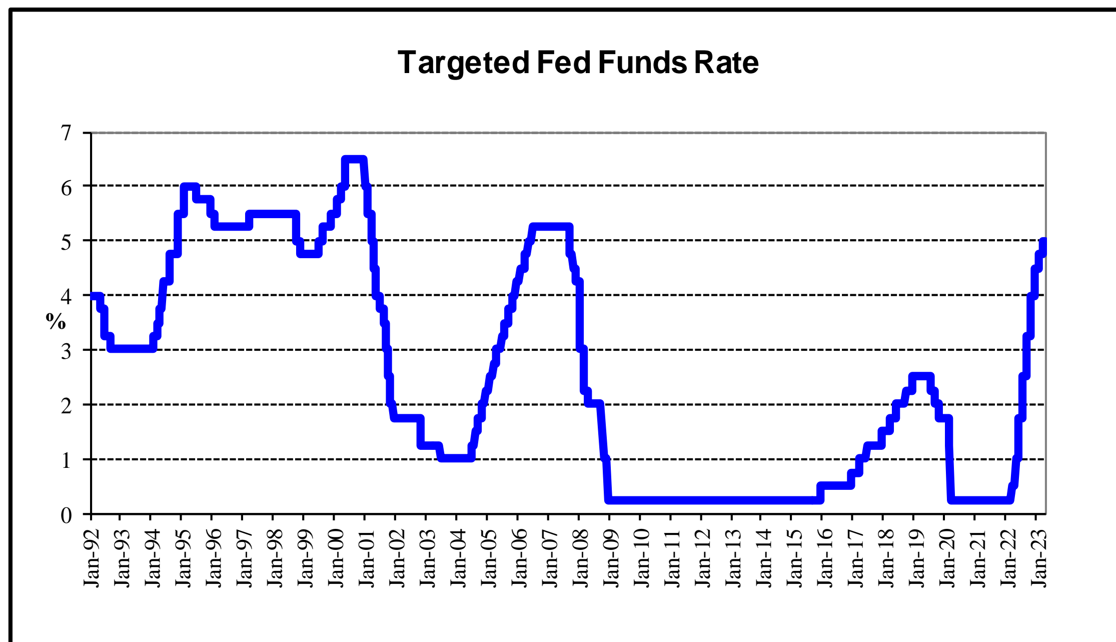
March 31, 2023

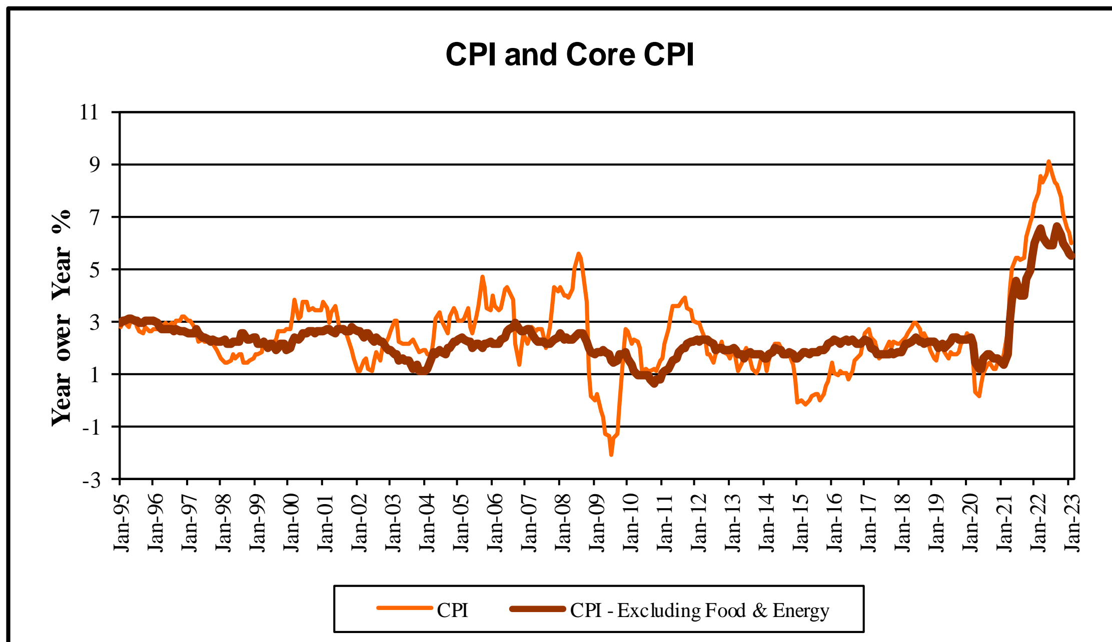
The late great philosopher Yogi Berra once said, "When you come to a fork in the road, take it." The Federal Reserve found itself at a fork in the road or, better yet, between a rock and a hard place at the March 21-22 Federal Open Market Committee (FOMC) meeting. It was caught in the cross current of turmoil in the banking sector that potentially presented threats to financial stability and the Fed's resolve to re-gain price stability. Having taken steps with the FDIC and the Treasury to protect depositors, and having created a new bank liquidity backstop, the Term Bank Funding Program (TBFP), the FOMC believed their efforts would soon contain contagion concerns, calm fears and restore confidence in the banking system. With the stickiness of inflation and year-to-date economic data largely stronger than expected, the FOMC unanimously elected to raise rates a ninth consecutive time. It lifted rates by 25 basis points to bring its benchmark targeted fed funds range from 4.75% to 5.0%, the highest level since September 2007. In sum, the Fed is using monetary policy tools to fight inflation and other tools to mitigate banking sector stress.



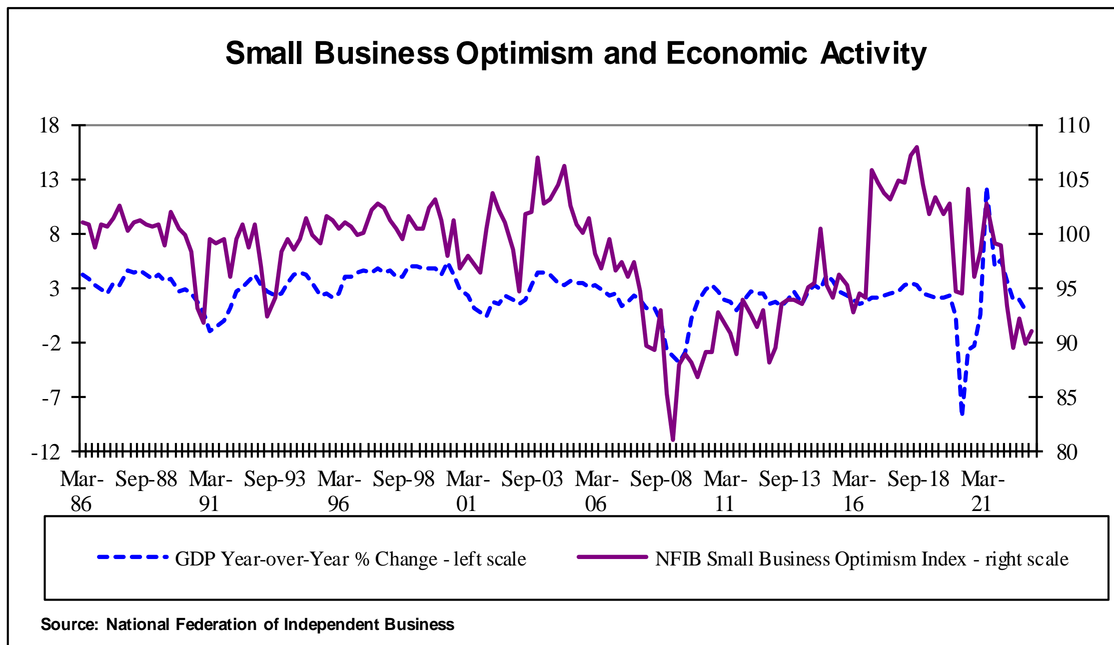
The post-meeting policy statement and press conference pulled back on forward guidance. Policymakers in previous statements said "ongoing increase" in policy rates would be appropriate. This was softened to "anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficient to return inflation to 2% over time." The FOMC statement acknowledged the financial situation that led to a tempered outlook.

> "Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring and inflation. The extent of these effects is uncertain."

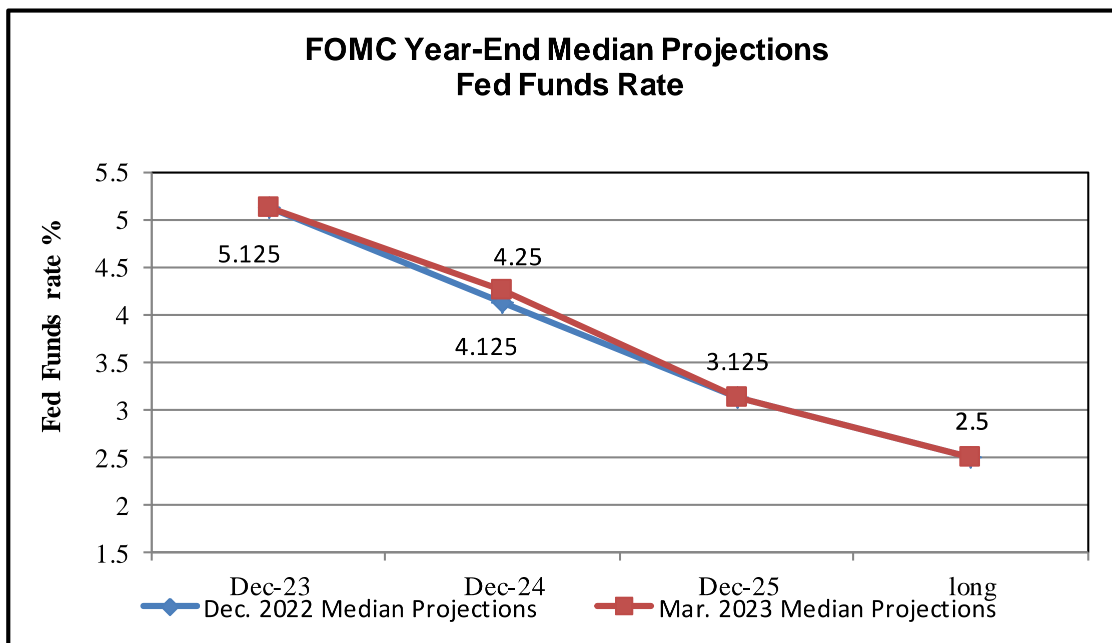
In his press conference Fed Chairman Powell said it was much too soon to know the effects the expected credit tightening will have on the economy. He also commented that tighter credit conditions could do some of the Fed's work for it in slowing demand and reducing inflationary pressures, i.e., substituting for further rate hikes.



The Fed continued to characterize the current state of the economy in favorable terms, even with some evidence that the aggressive rate hikes from 2022 are starting to catch traction. The economy started this year on an upward trajectory. The labor markets remain hot with job growth in February again far exceeding expectations. On the other hand, industrial production was flat in February as gains in manufacturing and utilities were offset by a decline in mining. Retail sales fell back 0.4% last month, but January's sales were revised up to a robust 3.2%. Still, meaningful cooling of inflation was absent in February's Consumer Price Index (CPI). The headline number was in line with market expectations, but the core, excluding food and energy prices, was a bit higher than anticipated. The year-over-year core CPI stands at 5.5%, well above the Fed's 2% goal. The Personal Consumption Expenditures (PCE) Deflators fared a little better, but clearly the Fed still has work to do.



Like the inflation gauge, not all the data has been upbeat. Sentiment surveys of small businesses and consumer remain downbeat. Auto sales are in decline and the housing market remains depressed, even with some tentative signs it may be bottoming out. The 11th consecutive decline in the Leading Economic Indicator (LEI) and the inverted yield curve can be seen as predicting a recession. The markets are convinced this economic cycle won't die a natural death, but that the Fed will kill it.



Fed Chairman Powell emphasized the degree of the expected credit tightening from the banking turmoil remains a major uncertainty for the outlook for the economy and monetary policy. Thus, it kept the door open for further monetary tightening. The Fed's "dot plot" remained relatively unchanged from the December version. The median level suggests one more 25 basis point rate hike this year, and no cuts until 2024. While providing banks with a blast of liquidity through the discount window and the TBFP program, the Fed also left its quantitative tightening program in place and unchanged. For now, the Fed remains on script, it will do what is necessary to bring down inflation, knowing it may require some economic pain to get there.

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