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The Bottom Line
Relevant Insights for the Savvy Investor

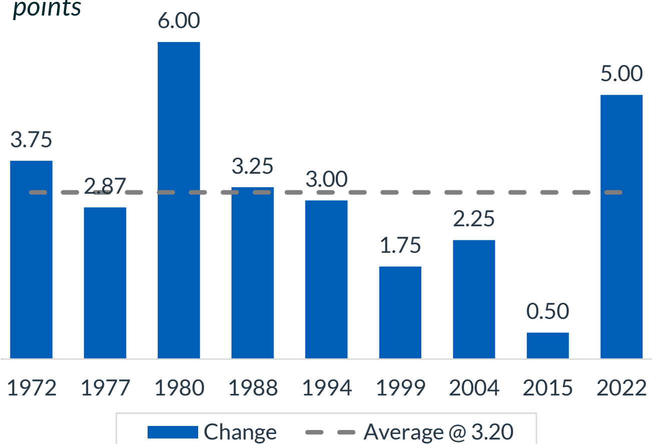
The Economic Downturn Is Still in the Cards

The next FOMC meeting will be on May 2, and the Fed is widely expected to raise the median federal funds rate by 25 basis points to 5.125%.

That will put the funds rate five percentage points above the level it was when they began raising interest rates in March 2022, marking one of the most rapid and extreme escalations of the funds rate in recent history (chart 1). The Fed is expected to pause future interest rate increases at that meeting. The Fed has projected that the funds rate will end the year at 5.125%, and many policymakers have stated there are no plans to cut the funds rate this year.

This pause will not bring an end to making economic conditions more restrictive. At the same time, the Fed will continue its quantitative tightening (QT), reducing the massive bond holdings it acquired during the aggressive stimulus it provided the economy during the early stages of the pandemic. The Fed started QT last June, allowing bonds to mature and not be replaced (chart 2). In doing so, it reduces the amount

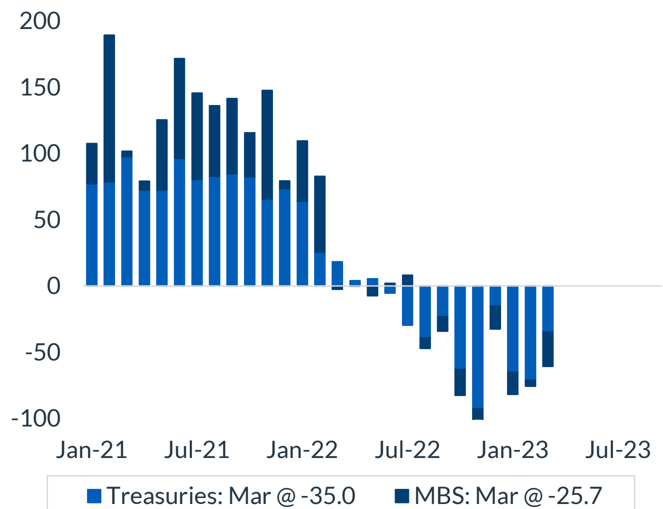
CHART 1: Federal Funds Rate
change in rate 14 months after initial hike, percentage points



Source: Federal Reserve, May 2023, assuming 25 bp hike at May 2, 2023 FOMC meeting.

This chart includes forecasted data post 4/28.
Information is subject to change and is not a guarantee of future results.

CHART 2: Fed Bond Portfolio - Monthly Change
$, billions



Source: The Federal Reserve, March 2023.

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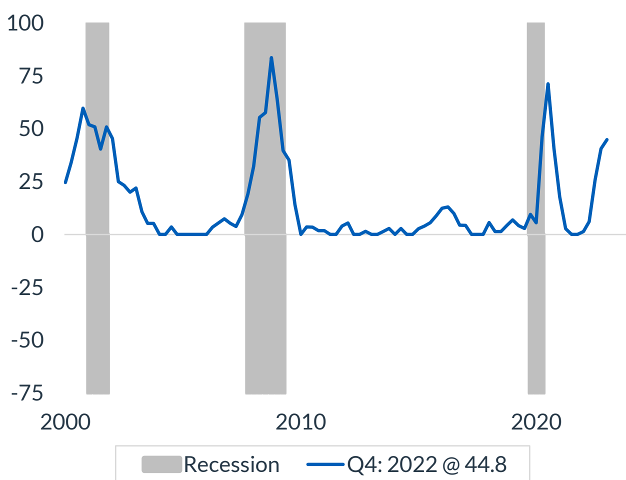
of reserves in the banking system by an equal amount. As a result, it tightens the availability of money, raising borrowing costs and slowing economic growth. Based on the pace of the last three months, the Fed will reduce the bond holdings by more than $875 billion annually, a large chunk of its $8.6 trillion balance sheet.

Another restriction on economic growth comes from the banking system. Due to the expected slowdown in economic growth and a high recession probability, banks have become far more restrictive in their policies toward lending. This can be seen in the quarterly survey of senior loan officials, where these restrictions are reaching levels associated with recent recessions (chart 3). They are also increasing the interest rate on loans due to higher interest rates and the higher cost of acquiring deposits, the primary source of funding for loans, due to the competition from money market funds.

The combination of higher interest rates and more severe credit standards is starting to cause stabilization and reduction in the major categories of lending (chart 4).

In the past year or so, the Fed has moved from a monetary policy stance that was very stimulative to one that is aggressively restrictive, with the funds rate well above the neutral rate. It has done so to reduce the demand for goods and services to bring down the high level of inflation. The Fed is entering a monitoring mode, observing how the economy will respond to the cumulative change in interest rates, tighter credit standards, and other new factors that may impact the economy.

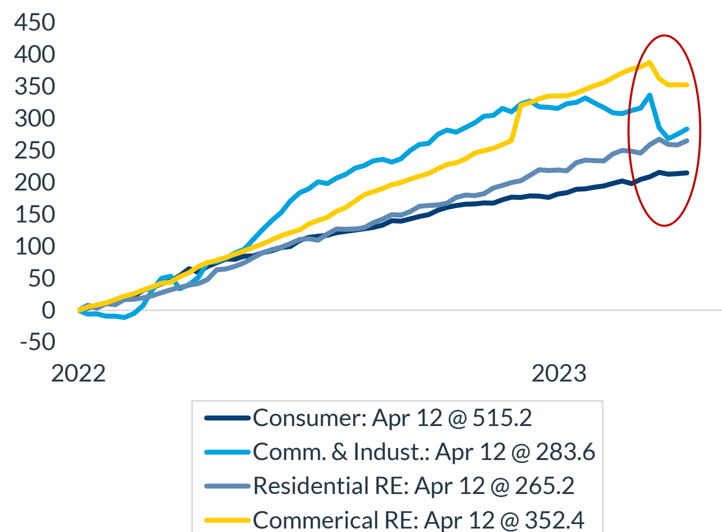
CHART 3: Tightening of Credit Standards
%, not seasonally adjusted



Source: The Federal Reserve, March 2023.

Information is subject to change and is not a guarantee of future results.

CHART 4: Lending at Commerical Banks
change in value since January 5, 2022 $, billions



Source: The Federal Reserve, as of April 12, 2023.

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Market Trends

After a very tough 2022, both stocks and bonds are off to a strong start to the year. However, it's been a volatile rise with concerns over the economy, the direction of Fed policy, and bank turmoil all driving wild swings in sentiment. Despite healthy market gains, the path forward from here may be challenging, especially as the economy weakens and potentially enters a mild recession, with continued downward earnings revisions the biggest risk for equity prices in the near term.

LABOR

The number of job openings peaked last March at 12 million and has fallen about 20% under the pressure of higher interest rates and slower economic growth.[1]

THE FED

With inflationary pressures remaining stubbornly resistant, the Fed is expected to keep the funds rate high throughout the year.[2]

HOUSING

The housing downturn appears to stabilize as spring buying demand is met with a limited supply of new and existing homes for sale.[3]

DEBT CEILING

Congress is beginning to debate raising the debt ceiling; Republicans want to curb spending, and Democrats want it passed without conditions.[4]

INFLATION

The yearly change in CPI has fallen to 5.0%, after peaking at 9.1% last June, as significant monthly increases from last year are falling off the annual calculation and being replaced with more moderate gains.[5]

OIL

Prices have fallen since peaking at $124/barrel last June, despite OPEC cutting back production. It is currently $78/barrel.[6]

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Sources

1. Bureau of Labor Statistics, February 2023
2. CNR Research, April 2023
3. US Census Bureau, National Association of Realtors, April 2023
4. Wall Street Journal, April 2023
5. Bureau of Labor Statistics, February 2023
6. Bloomberg Energy, April 2023

Index Definitions

The Consumer Price Index (CPI) measures the monthly change in prices paid by U.S. consumers.

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