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MARKET SIGHT LINES

Unwinding Pandemic Distortions: The Federal Reserve Holds Rates Steady, Maintaining Its Restrictive Policy

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Since March 2022, the Federal Reserve (Fed) has hiked its funds rate by 5.25%, ushering in a higher rate regime that is leading to a Fiscal Transition, where the major participants of our economy – the consumer, businesses, and the government – must learn how to live with higher interest rates. In its meeting this week, the Fed kept its funds rate steady at 5.25%-5.50% and will continue to shrink its securities holdings, a restrictive policy that will likely keep market interest rates higher for longer. The Fed continues to battle high inflation resulting from pandemic-related distortions in both the supply and demand side of the economy.

In this Sight|Lines, we unpack the learnings from the latest Fed meeting and discuss the implications.

THE TAKEAWAY: THE FED HOLDS STEADY TO UNWIND DISTORTIONS … AND WAITS.

The Fed kept its currently restrictive policy steady at this week's meeting, sharing insights from its meeting and where we might go from here. In summary:

- Recent economic growth has been stronger than the Fed, or really anyone, expected.
- The Fed statement was little changed, acknowledging strong economic growth and a less tight job market.
- In his press conference, Chair Jerome Powell reinforced the Fed's commitment to lower inflation.
- The Fed will continue to be data dependent and could well keep rates elevated for some time.
- The Fed's policy debate appears more balanced, but is still focused on further rate hikes, not cuts.
- The full effects of the restrictive monetary policy are still to be seen.

The pandemic triggered historic economic distortions and high inflation. The Fed's highly restrictive policy is designed to unwind those distortions and cool inflation, and the full policy effects are yet to be felt.

IN-DEPTH: THE FED HOLDS STEADY ITS RESTRICTIVE MONETARY POLICY TO FURTHER UNWIND PANDEMIC DISTORTIONS, WITH THE FULL EFFECTS OF HIGHER RATES STILL TO BE FELT.

The Fed kept steady its currently restrictive policy with a high funds rate and continued shrinking of its balance sheet. The full policy effects, such as cooler inflation and an economic slowdown, are still to be felt. Going deeper:

- The Fed, and really everyone, has been surprised by the strength of the first estimate of third quarter GDP:
    - The headline rate showed 4.9% annualized growth.

    - While inventories, which can be volatile, were a positive contributor, the consumer was the main driver of growth, contributing more than half of the 4.9% rise in GDP.
- The Fed statement was little changed, but edits were important. Revised statements include:
    - "…economic activity expanded at a strong pace in the third quarter."
    - "Job gains have moderated since earlier in the year but remain strong…"
    - "Tighter financial…conditions…are likely to weigh on economic activity…"
- In his press conference, Powell reinforced the Fed's commitment to lower inflation, saying:
    - "We understand the hardship that high inflation is causing, and we remain strongly committed to bringing inflation back down to our 2% goal."
    - "… without price stability we will not achieve a sustained period of strong labor market conditions that benefit all."
- Other learnings from the press conference include:
    - The Fed will continue to be data dependent: "We will make decisions about the extent of additional policy firming and how long policy will remain restrictive based on the totality of the incoming data, the evolving outlook, and the balance of risks."
    - Policy debate appears a bit more balanced, but is still focused on further rate hikes:
        - "The risks of doing too much versus doing too little are becoming more balanced."
        - "… the committee's not thinking about rate cuts right now … We're still very focused on the first question, which is have we achieved a stance of monetary policy that's sufficiently restrictive to bring inflation down to 2%…?"
    - The full effects of the restrictive monetary policy are still to be felt: "The stance of policy is restrictive, meaning that tight policy is putting downward pressure on economic activity and inflation, and the full effects of our tightening have yet to be felt."

Both the supply and demand sides of our economy experienced historic distortions during the pandemic, leading to runaway inflation. The Fed continues to respond with a highly restrictive policy, seeking to unwind those distortions and cool inflation. The full effects of Fed policy are still to be felt.

CONCLUSION

After each Fed meeting, we learn a lot about what Fed officials are thinking as they debate monetary policy and how it is affecting the economy. At its meeting this week, the Fed kept steady with its currently restrictive policy, signaling progress to cool inflation has been made, but more is needed. A sustained restrictive policy has implications. We're in a higher rate regime, which is leading to a Fiscal Transition. Consumers, businesses, and the government must learn how to manage higher interest rates, and each of these segments of the economy will experience pain as a result. We will remain keenly focused for some time on these implications, paying particular attention to the economic pain and any resulting effects on market conditions.

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