Manulife Investment Management

Market Note

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Although the US Federal Reserve (Fed) did exactly what the markets expected on 14 December by raising policy rates by 50 basis points, it might not be wise to write the latest interest-rate decision and the accompanying press conference off as nonevents.

If investors were to hear about the Fed's decision to increase its policy rate to 4.25%-4.5%, read the accompanying statement, or watch the initial market reaction to the rate hike, they could be forgiven for thinking that the day's events were entirely unremarkable. A closer read of the Fed's Summary of Economic Projections, however, will have painted a slightly different picture, which is also reinforced by parts of Fed Chair Jerome Powell's press conference.

The Fed reiterates its hawkish bias

The most notable nugget of information to emerge from the meeting was the adjustment to the projected federal funds rate, which Fed officials have raised to between 5.00% and 5.25% (with a median rate of 5.1%) by the end of 2023, with the bias clearly still being higher. Chair Powell doubled down on the messaging during his press conference, reminding us that each time the FOMC committee revised its expectations over the course of 2022, rates were pushed higher. His statement was somewhat softened by the suggestion that future rate decisions will be data dependent and that we're close enough to peak policy rates, thereby warranting a slower pace of rate rises to come. The message was clear though: The Fed intends to hike rates—albeit less quickly than in 2022—and keep them elevated for longer, despite expectations for weaker growth and higher unemployment, as outlined in other parts of its latest projection.

Into 2023: what comes up must NOT come down, or so the Fed claims

Despite the doggedly higher rate projections, there's nevertheless a clear sense that the Fed is close to winding down its hikes in order to properly assess the impact of 2022's tightening. We've elected to take the more conservative view and expect the Fed to deliver a final rate hike at its March meeting, with the policy rate peaking at 5.25%. We readily concede that rates could wind up 0.25% lower or that the hiking cycle could extend into May; the exact timing and magnitude of the final rate hike will, at this stage, be truly dependent on inflationary data, with modest sequential prints and decelerating year-over-year growth data being critical factors. The good news is that the last couple of CPI releases have clearly signaled that inflation for goods has flattened on a month-over-month basis. Even services inflation, excluding shelter—which is likely going to garner the most attention in 2023—has stabilised for now.

As soon as the Fed stops hiking rates, markets will be clamoring to find out when the first rate cut could occur. The answer from the Fed is that we should expect to stay pegged at peak rates for an extended period of time in order to avoid the mistakes of the 1970s and to ensure that inflation returns to its 2% target. Taken together, this implies that policy easing is likely to take place sometime in 2024.

That's not how we—or the markets—see it

We have a different view: We expect the Fed to begin easing before the end of 2023. That begs the questions of how do we get there, and what are the key signposts that can tell us we're on our way?

First and foremost, while we wouldn't expect inflation to fall back to the Fed's 2% target, we would need to see a clear and sustained moderation in inflation. Month-over-month data on prices appears to be reverting to more normalised levels—that's a positive. Specifically, easing core goods inflation has been providing a welcome respite from the uncomfortably high readings we saw in Q3, and it's likely to provide continued relief to those areas most distorted by the pandemic and Russia's invasion of Ukraine.

The trickier part is cooling services inflation (ex-shelter) because that's usually driven by wage growth and is, in our view, the bigger risk for persistently higher inflation over the medium term. Unfortunately, the most likely way that this component will cool is through a recessionary environment. As such, a cooling labor market is a necessary precondition for services inflation to ease. We would expect to see a deterioration here in the early months of 2023.

The bottom line

The good news is that inflation is finally coming down far enough to allow the Fed to consider pausing its tightening actions. The bad news is that we believe that the next phase of Fed policy—monetary easing—will more likely be driven by deteriorating economic conditions than by a more benign soft landing.

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