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Every Federal Open Market Committee meeting is important to the markets and carries a certain significance that may not be immediately obvious. That said, not all meetings are equal. In our view, the decision from the 22 March Fed meeting will be a particularly critical and potentially *pivotal* one for investors. Frances Donald, Global Chief Economist and Strategist, Multi-Asset Solutions Team, discusses three questions for the Fed's 22 March decision.

Three questions for the Fed in the lead-up to its March meeting

For starters, the March 22 meeting will mark the one-year anniversary of the first interest-rate hike of what would become the most aggressive rate hike cycle in U.S. history.

Many within the investment community generally agree that the rate hikes implemented this year were necessary. The U.S. Federal Reserve (Fed) had to act in the face of an exceptionally strong labor market *and* the highest level of inflation the country has experienced in decades.

However, less than two weeks before what should have been another straightforward rate hike to contain still-elevated levels of inflation, the unexpected happened: Concerns about rising stress in the global banking system sparked fears of a banking crisis. The operating environment darkened swiftly, bringing with it important implications for the Fed.

As we noted previously, stresses in the U.S. banking system—which, at a minimum, had been indirectly aggravated by prior Fed decisions—have created a substantial uncertainty shock that has increased the odds of further material tightening of lending standards and heightened the already-high chances of a recession in 2023.

In other words, the Fed's job just got *much* more difficult.

The central bank now needs to assess whether the support package it put together with the Federal Deposit Insurance Corporation and the U.S. Treasury has successfully eliminated risks of contagion and stopped the event from morphing into a full-blown banking crisis. A crucial part of that task involves questioning if more interest-rate hikes might further destabilize an already jittery financial system.

The Fed will also need to recalibrate its inflation outlook to take into account a rapidly evolving macroeconomic environment as different pockets of stress in the financial system emerge, and what they could mean for the real economy. The bank has to determine if the costs of implementing interest-rate hikes now might outweigh the benefits that such a decision might bring. Worse, the Fed will need to come to a conclusion within a matter of *days*.

We believe the Fed will choose to move ahead with a 25 basis point (bps) hike, with markets assigning about a three-quarter probability of such a move[1]; however, the interest-rate decision on March 22 may turn out to be the *least* important news that day. Here are three questions that we have relating to the Fed's thinking that we believe are more relevant to the markets.

[1] Bloomberg, as of 17 March 17, 2023.

1. Right tools for the right job—to what extent will the Fed separate its financial stability responsibilities from its price stability mandate?

As news of stresses in the banking system spread, the market response was to substantially reduce the implied probability of rate hikes in 2023 while also pricing the likelihood of cuts as early as mid-year. The implication here is that markets view financial (in)stability as a constraint on monetary policy and, in this instance, as a limit on the Fed's ability to continue raising interest rates to combat inflation. But the tension between financial stability and price stability isn't a new one; there's certainly no shortage of central bank research[2] on the topic. Mark Carney, former governor of both the Bank of Canada and the Bank of England, for one, spilled plenty of ink in asking "whether the policy rate itself should lean into the wind for financial stability purpose." The conclusion he came to is that it certainly should *not*.

Can the Fed afford to hike rates and maintain a sound financial system at the same time? Former Fed Chair Ben Bernanke made it clear in his very first speech as Fed governor that it's better to rely on targeted measures such as financial regulation and supervision to promote financial stability rather than monetary policy. He said then—and has repeated many times since—that the Fed should use the right tools for the job. European Central Bank (ECB) President Christine Lagarde seems to be on the same wavelength: On March 16, the ECB announced a 50bps hike and stated that there is no trade-off between price stability and financial stability.

Whether Mr. Powell agrees with his European counterparts and his predecessor is important: If he chooses to emphasize that the Fed has precision tools to deal with financial instability (and it won't be the bank's interest-rate policy), the market may need to reassess its current assumption that jitters in the banking system necessitate an end to the hiking cycle. Should he appear to take another perspective, then perhaps the Fed put may be back in play very quickly.

[2] Banque de France, the European Central Bank, Bank of Canada, and the Bank for International Settlements, for instance, have all produced research on the subject.

2. Will the Fed push back against market expectations that rate cuts could materialize at year end?

Expectations among Fed forecasters of what could happen on March 22 range from a 25bps rate *cut* to a 25bps *hike*. As long-term investors, we don't think it's wise to focus solely on that. The far more important question is whether markets have gotten the story right on longer-term policy rates. In the week leading up to the March Fed meeting, the market has gone from pricing a total of four rates *hikes* by the end of 2023 to three interest-rate *cuts* before settling on just *one* cut.[1]

Although the swings in expectations took place against a backdrop of extreme market volatility, Chair Powell may conclude that premature expectations of cuts could undermine the progress that's already been made on the Fed's dual mandate. Should he decide to use the post-Fed meeting press conference as an opportunity to push back against this medium-term pricing, it could spark a rerating of rate hike expectations (i.e., pricing in more rate hikes).

Indeed, it wasn't that long ago that Chair Powell famously said "we are not even thinking about thinking raising rates." Could he now say instead that the Fed isn't even thinking about *cutting* rates? That may be more important—and certainly more critical to the market—than the actual rate decision at the upcoming Fed meeting.

3. Is the Fed reassured by recent disinflationary dynamics?

If we're right about the Fed being uncomfortable with using monetary policy to target financial stability, the markets will need to shift their focus back to inflationary dynamics in the United States—specifically, how the bank may have viewed the price data of the past few weeks, especially in light of recent market volatility.

Yes, standard measures of inflation are important. The Consumer Price Index appears to be moderating, but it remains at uncomfortably high levels; meanwhile, the Producer Price Index and import prices are declining—all of which point to progress but, certainly, a job that isn't quite done. Add to this real-time disinflationary dynamics that have come into play in the week leading up to the Fed meeting, which makes the interest-rate decision less clear cut.

First, market-based inflation readings have receded after an uncomfortable climb in early March that might have unnerved several Fed officials. Second, related to the previous point, oil prices are now down around 45% from their peak in March 2022[1] and could provide significant relief to a wide range of inflation data. Third, financial conditions have tightened on the back of recent events—an indicator that Chair Powell is watching closely. These developments may have just occurred, but they've also likely alleviated some of the inflationary concerns held by Mr. Powell and his colleagues. Will they acknowledge these improvements—which would suggest that the Fed may be less panicked about the possibility of entrenched inflation—or would Fed officials choose to focus on the fact that inflation is still too high and too far from the bank's 2.0% target?

Ultimately, while markets may be more interested in Mr. Powell's comments about the financial system, we believe a great deal of the Fed's outlook will still be informed by inflation and the bank's assessment of how it will evolve.

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