AEGON Asset Management

FOMC UPDATE: A DOVISH HIKE

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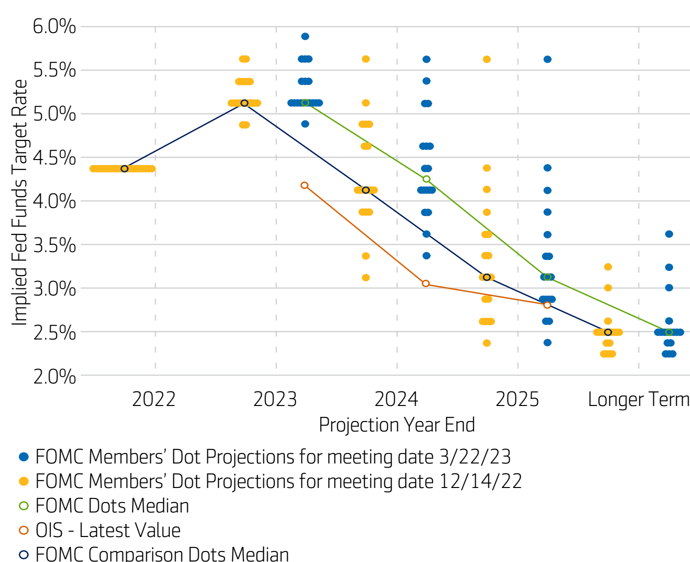
At the conclusion of one of its more anticipated meetings, the US Federal Open Market Committee (FOMC) hiked rates by 25 basis points. This was broadly expected, although the recent turmoil in the banking sector had created a high degree of uncertainty as to whether or not the FOMC would proceed with a 25 basis point hike or stand pat.

The FOMC's only commentary in its statement acknowledging this turmoil was the following: "The US banking system is sound and resilient. 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. The Committee remains highly attentive to inflation risks." Adding later, "The Committee will closely monitor incoming information and assess the implications for monetary policy. The Committee anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time." Importantly, its dot plot was largely unchanged from December, only indicating a policy rate .125% higher in 2024 versus the previous estimate (see exhibit 1).

Exhibit 1: FOMC dot plot



Source: The Federal Reserve. As of March 22, 2023.

Essentially, the Committee didn't appear willing to abandon its inflation-fighting regime due to the recent banking turmoil, while simultaneously acknowledging the uncertainty of how much the tightening in lending standards will impact the economy. From this perspective, downshifting from an expected hike of 50 basis points just a few weeks ago to 25 basis points today made a lot of sense.

The market interpreted the FOMC's statement and subsequent comments made by Chairman Powell in his press conference as relatively dovish. This "dovish hike" led to a significant rally in Treasurys, emboldening expectations the FOMC will "pivot" monetary policy and start cutting interest rates by mid-year. This steepened (i.e., less inverted) the 2-10 curve by about 10-12 basis points post meeting.

We believe these views that the FOMC will cut soon are misplaced, instead expecting the factors driving inflation to be largely unaffected by the recent turmoil. Specifically, we believe the imbalances in the labor market will persist for some time, and the FOMC is unlikely to pivot until this situation is resolved.

In order to achieve this, we believe the unemployment rate will need to rise by at least 1.00%, possibly more. As such, we expect the FOMC will keep rates at or above current levels through the end of this year, potentially well into 2024. Chair Powell said as much during his press conference, but the market shrugged it off. We expect to see similar public comments as Powell's from Committee members in the coming days, which could pressure front-end rates higher, although it may take upcoming inflation data for the message to finally sink in. While volatility remains high, Treasurys are likely to remain expensive as we also expect a flight to quality.

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