# MARKET COMMENTARY

## The Fed is done with rate hikes, credit squeeze is a concern

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- **In rising the policy rate by 25bps to 5%-5.25% the Fed also signalled the end of the tightening or at least the beginning of a long pause. From now on decision will be taken meeting by meeting, as the tightening of credit conditions will have an uncertain impact of the economy, which is not compatible with any guidance on policy decision.**
- **The state of the banking sector and its fallout on the economy is now the Fed's main concern. Powell reassured again that the emergency phase is finished with the sale of first Republic to JPM and that the industry is solid. Still regulation will be tightened especially for medium sized institution**
- **Yet, with inflation set to decrease only slowly is far too early to expect rate cuts. The resilience of the labour market in the face of the sharp monetary squeeze should allow the economy to escape a recession, according to Powell. We remain less optimistic and stick to out view of two rate cuts in Q4.**

As widely expected, the Fed delivered the 25bps hike that put the fed funds rate in line with the dots of the September meeting, with a unanimous decision. The press release dropped the reference to "additional policy firming" made in March. It also sought to reassure on the state of the banking sector, but tighter credit and its uncertain impact on activity took the priority in the Fed's assessment of the situation.

The state of the banking sector and the implications of tighter lending standards, espcially by smaller banks are the focus of the FOMC's attention. According to Powell, with the sale of First republic to JPM the resolution of three troubled bank is completed and should mark the end of the emergency period. Still, the demand for Fed's liquidity facility remains elevated (chart at the bottom on the right) even excluding the liquidity injections for the "bridge" banks created to manage the day-to day activity of Silicon Valley Banks and Signature Bank after they were closed. Going forward supervision and regulation of medium size institution will have to be strengthened and, more broadly, regulation will have to keep up with the unprecedented speed of the run on Silicon Valley bank

Now the focus is on the impact of much tighter lending standards (especially by smaller banks) on growth and employment. In March Powell said that the rightening in credit standard they FOMC expected is roughly equivalent to a 100 bps increase in the policy rate: now these estimated are more uncertain but Powell conceded that the without the credit squeeze the fed would have been forced to a higher peak in rates.

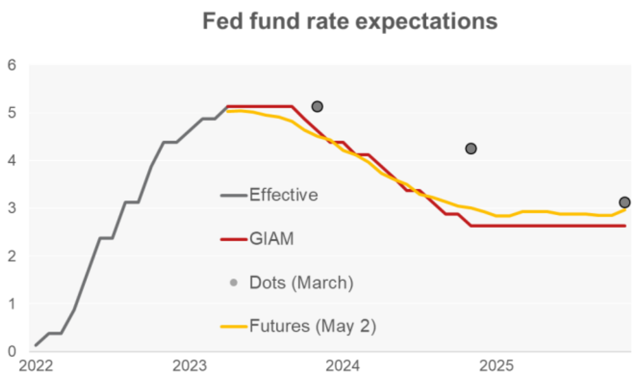
While the full extent of the 500-bps rate increase since March 2022 has t yet to show up, chair Powell signalled that the economy is indeed slowing down visibly especially in housing and other interest rate sensitive sectors. The labour market remains tight but there is increasing evidence that demand and supply are going back into balance with labour market participation increasing and vacancies decreasing. Powell remains convinced that a recession can be avoided despite the sharp and fast monetary squeeze and expect GDP to continue to growth at a moderate pace in the next quarters. The difference with respect to past episodes is the strength of labour demand. After 500 bps of tightening, the unemployment rate remains at a record low (3.5%), this increases the odds that the labour market can cool down without the usual spike in joblessness. He also pointed out that the Fed's staff, in its independent forecast, does assume a mild recession, but accompanied by an overall modest increase in unemployment.

Inflation has moderate but the core PCE rate remains at 4.7% yoy indicating that there is still a long way to go towards the 2% target. Wage growth, at around 5% is some 2pp higher than what is consistent with a 2% inflation and getting there requires a much softer labour market. Powell was quick to point out that wage growth is just one of the causes of the current inflation and it is difficult to establish a precise causation chain between wages and prices. Profit margins play a role too, but he attributed them just to supply bottlenecks. Once they are solved competition will bring margins down.

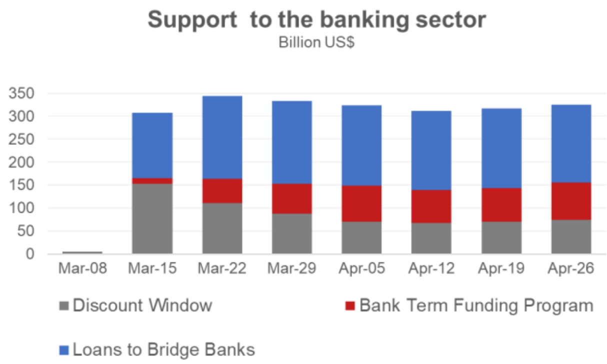
The huge uncertainty on the ultimate impact of tighter credit on the economy is incompatible with any firm guidance on any further step by the FOMC.  The next decisions will be fully data depended: however, Powell noted that rates are now at the median dots of the March projection and that QT is proceeded as planned, draining liquidity. Overall, the level of real rates and the response of capex show that the policy is tight enough. A pause at this meeting was not taken in consideration and Powell once again pushed back against expectations of rate cuts before the end of the year. Markets expect cuts already in the summer based on a much steeper path of disinflation than the one projected by the Fed, Powell remarked: the Fed sees core PCE inflation ending the year at 3.6% and this would be still incompatible with rate cuts. Moreover, inflation stabilise at 3% will not be enough for the Fed to ease the pressure. Our forecast has a slightly lower year end inflation (3.4%) and above all, foresees an outright GDP contraction in H2, which would push the Fed to cut  rates in the last two meetings of 2023

Talking about the debt ceiling standoff, Powell warned that a debt default would push the country into unchartered water and that the Fed could not do much to shield the economy and financial system from the fallout.

Reassurance on the end (or a substantial pause) of the hiking cycle pushed down the yield of the 2yr Treasury by 10 bps to 3.85% while the 10 yr yield lost 8 bps to 3.35%. The S&P 500 appeared more sensitive to the risks for the banking sector and lost around 0.5%




Source: Federal Reserve Board, Refinitiv, GIAM




Source:Federal Reserve Board, GIAM

| Variable | Prev. FOMC meeting | Latest | Chg. |
|---|---|---|---|
| Real Activity | | | |
| Weekly activity index (yoy GDP) | 1.1 | 1.1 | 0.0 |
| ISM - Manuf | 46.3 | 47.1 | 0.8 |
| ISM - Services | 51.2 | 51.9 | 0.7 |
| Macro Surprises | 52.2 | 12.5 | -39.7 |
| Labor Market | | | |
| Payroll growth (3 mth. MA) | 345 | 345 | 0 |
| Unemp. Rate | 3.6 | 3.5 | -0.1 |
| Unemp. Rate (broad) | 6.8 | 6.7 | -0.1 |
| Hourly wages, % yoy (3 m. MA) | 5.3 | 5.2 | -0.1 |
| Prices | | | |
| Core CPI | 5.5 | 5.6 | 0.1 |
| Core PCE | 4.7 | 4.7 | 0.0 |
| Trimmed PCE | 4.7 | 4.7 | 0.0 |
| U. Mich 5 yr exp. | 2.9 | 3.0 | 0.1 |
| NY Fed 3 Y exp. | 2.7 | 2.8 | 0.1 |
| 5Y5Y fwd exp. | 2.3 | 2.2 | 0.0 |
| Financial Conditions | | | |
| Chicago Fed index* | -0.2 | -0.3 | -0.1 |
| 10 yr. Treasury | 3.4 | 3.4 | 0.0 |
| - Risk neutral Component | 4.1 | 4.2 | 0.0 |
| - Term Premium | -0.7 | -0.7 | -0.1 |
| Yield curve (10Y - 3m) | -1.2 | -1.8 | -0.6 |
| S&P 500 | 3937 | 4120 | 4.6% |
| Trade Wighted Dollar | 128.7 | 128.1 | -0.5% |
| WTI Crude Oil | 70.8 | 71.7 | 1.2% |
| * Decrease: looser conditions | | | |