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BREAKING NEWS
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With markets upbeat, the Fed struggles to keep things tight

The U.S. Federal Reserve continues to slow its pace of rate hikes, but we expect it to deliver at least a few more 25 basis point increases to prevent financial conditions from loosening more than they already have. Markets are pricing in rate cuts as soon as this fall.

Brian Nick
Chief Investment Strategist

WHAT HAPPENED?

The U.S. Federal Reserve eased up on the brakes just a bit more, delivering a 25 basis point (bps) interest rate hike after 75 bps and 50 bps increases at the prior two meetings. Its policy rate range is now 4.50% - 4.75%, the highest since 2007.

With new economic and policy forecasts not due until March, markets focused on changes to the Fed's statement. While it acknowledged the recent slowing in several measures of inflation, it also kept the phrase "ongoing increases" to characterize its expectations for policy going forward. Back in December, the Fed published a median 2023 interest rate forecast of greater than five percent, which would mean rate hikes are in store at both the March and May meetings.

Fed Chair Jay Powell's press conferences have, in recent months, been sources of volatility as investors struggle to interpret his comments. Markets often feel one way in the moment, then wake up the next morning with a change of heart. In his comments following this meeting, Powell continued to emphasize the lack of balance in the labor market and the risk it presents to ongoing firmness in wage growth, which the Fed considers a risk to keeping inflation elevated for longer. This signals that he sees further rate increases as necessary and is in no rush to reverse recent hikes with rate cuts "for quite some time."

STILL SEARCHING FOR A SOFT LANDING

The year 2023 has thus far represented a welcome 180-degree turn from 2022 for investors. Since the Fed's open market committee last met, pretty much every asset class has rallied. Such a rapid and broad-based easing of financial conditions is unusual during an aggressive monetary tightening cycle in which the consensus forecast for the U.S. economy is still at least a mild recession.

The Fed now faces a difficult task as it searches for a way to wind down its rate hikes without causing conditions to ease further, which could lead inflation to rise again later in the year. To guard against this, we expect repeated firm commitments not to cut rates from their peak until 2024. Fed speakers have been saying this for months, but markets have not gotten the message. Another round of hawkish speeches and a new set of sober forecasts at the March meeting are likely in store.

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Even with more rate hikes looming, the rapid decline in inflation, coupled with impressive labor market resilience, has lowered the probability of an imminent recession. A soft landing looks more likely as consumer spending slows to a more normal rate and real income growth turns positive. But the possibility of no landing at all, in which growth stays strong, inflation fails to fully moderate and the Fed needs to keep hiking, cannot be ruled out.

WHAT'S GOING TO WORK FOR INVESTORS?

Markets are pricing in close to a best-case scenario for the U.S. economy this year: positive growth, rapid disinflation and continued easing of financial conditions. This may bear out, but there are considerable risks to the simultaneous rallies in stock and bond markets from here.

Because we still think the Fed will hike a bit more than markets expect – and hold rates higher for longer – we cannot rule out a return to the market conditions that prevailed in 2022. Unless and until the Fed relents from its stance, we are positioned for a return to an environment led by defensive sectors in which higher quality and shorter duration assets are mostly likely to perform well.

We came into this year bullish on investment grade and high yield corporate credit, as well as municipal bonds, and that view has not changed despite the impressive rally across those segments. We are also encouraged by the reopening in China and the better economic news out of Europe, which have made us less negative on non-U.S. asset classes even as the dollar has given back some gains.

While we are convinced that 2023 will continue to be a more hospitable year for investors than 2022 – not a high bar, to be sure – we are not looking for a full bounce back to prior market highs until we are convinced that disinflation can continue without a severe weakening of the economy.

A RISK TO WATCH: THE U.S. DEBT CEILING

And now for something completely different. We have been deluged with questions about the U.S. debt ceiling and the potential that the U.S. Treasury could default on its debt as soon as June. Many investors remember the pain of 2011 and 2013, when markets reacted quite negatively as Congress waited until the very last minute to authorize the Treasury to borrow in order to cover Congressionally appropriated expenses.

The U.S. debt ceiling has already been reached, and the Treasury only has enough accounting tricks in its bag to push off the emergency until the late spring. We do not see any of the proposed "unconventional" solutions – minting a $1 trillion coin or prioritizing debt repayments over other expenses – as feasible. The ceiling must be raised or suspended or the U.S. will be in default.

Republicans in control of the U.S. House of Representatives have strongly hinted they will be unwilling to authorize a debt ceiling increase without certain concessions, but they have not provided any details as to what those concessions might be. But given that cuts to Social Security, Medicare and the defense budget seem to be off the table, it seems likelier to us that the real fight will happen in September, when last year's budget runs out and a government shutdown occurs unless new appropriations are passed.

The most likely scenario, therefore, would see Republicans agreeing to suspend the debt ceiling for a few months and wrap it into the broader negotiations with Democrats over discretionary spending later in the year. Past shutdowns have been negative for both markets and the economy over short periods, most recently in late-2018, but the risk falls far short of what we'd see in the event of a Treasury default. We are not making any changes to our investment posture due to the debt ceiling at this time.

For more information, please visit us at nuveen.com.

Endnotes

Sources

Federal Reserve Statement, February 2023.

Bloomberg, L.P.

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