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## Fed Hits the Pause Button, Without Saying Pause!

As widely expected, the Federal Reserve hiked interest rates by 0.25% and hinted that it may be the final move in the most aggressive tightening campaign since the 1980s. The increase lifted the Fed's benchmark federal funds rate to a target range of 5% to 5.25%, the highest level since 2007, up from the zero bound early last year. The vote was unanimous.

The official statement said, "The committee will closely monitor incoming information and assess the implications for monetary policy." It omitted a line from its previous statement in March that said the committee "anticipates that some additional policy firming may be appropriate." So, it appears the Fed is now data dependent, and the pause is here. Currently, the market is pricing in only a 10% chance of a rate hike at the June meeting and potential for rate cuts later this year. That is certainly at odds with the Fed's desire for higher for longer.

In our annual Market Outlook we published in January we said, "Recent Fed speak suggests the Fed will hike overnight rates to 5% - 5.25%, where we suspect they will consider policy to be 'sufficiently restrictive'. From there we expect the Fed to pause and give the policy tightening time to work through the economy. The Fed has historically waited a median of about 8 months from their last rate hike to the first rate cut, which means the earliest we should expect a rate cut is in the 4th quarter. But bonds could easily continue the rally that started in October before the Fed cuts on signs of economic slowing, which would take the 10-Year Treasury Note yield down towards 3%."

The 10-Year Treasury Note yield has fallen from a peak of 4.23% in October 2022 to a recent low of 3.29%, following the script of peaking prior to the last Fed rate hike. Inflation has moderated, and market-based inflation expectations have crumbled in recent weeks. For example, the one-year and two-year inflation breakeven rates have fallen to nearly 2.0% from as high as 3.5% in early March.

What happens next with rates, in our opinion, is largely dependent on the impact on bank balance sheets from the ongoing situation in regional banks and the drama about to unfold with the debt ceiling debate and risk of default. We believe those risks and the media buzz around them are meaningful and potentially market moving.

Historically, in the ten rate hike cycles since 1965, between the last hike and first rate cut, the 10-Year Treasury Note yield fell by an average of 71 basis points (yields fell in 9 of 10 cases) and the yield curve, as defined by the 10-Year - 3-Month T-Bill spread, steepened in each case.

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According to Rosenberg Research, the Fed always cuts rates after they cause a financial event as demonstrated below:

#### INITIAL FINANCIAL FAILURES AND HOW THE FED REACTED IN THE NEXT 3-6 MONTHS

- Franklin National Bank (October 1974): -250 bps
- Penn Square Bank (July 1982): -300 bps
- Continental Illinois (May 1984): -150 bps
- Lincoln Savings (April 1989): -50 bps
- Long-Term Capital Management (August 1998): -75 bps
- New Century Financial (April 2007): -75 bps
- Silicon Valley Bank (March 2023): ???

As always, we believe it is imperative for investors to stay focused on their long-term goals and not let short-term swings in the market derail them from their longer-term objectives.

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The 3 Month Treasury Bill Rate is the yield received for investing in a government issued treasury security that has a maturity of 3 months. The 3 month treasury yield is included on the shorter end of the yield curve and is important when looking at the overall US economy.

The 10 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 10 year. The 10 year treasury yield is included on the longer end of the yield curve. Many analysts will use the 10 year yield as the "risk free" rate when valuing the markets or an individual security.

The index of leading economic indicators (LEI) is intended to predict future economic activity. Typically, three consecutive monthly LEI changes in the same direction suggest a turning point in the economy.

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