

In light of the turmoil in the banking sector, some have called the March Federal Open Market Committee (FOMC) meeting announcement the most anticipated in recent memory. Let's unpack what was done and communicated:

Hike in Fed Funds to 4.75% - 5.0%:

The widely anticipated policy move was a downgrade from the 0.5% move that was increasing in likelihood prior to the failure of SVB and others. Some market participants expected the Fed to pause as it digested the impact of the recent turmoil. However, there was a risk that the market would have read that as a confirming indication that a more serious problem was afoot, not to mention compromising their inflation-fighting credibility. In the presser, Powell acknowledged not hiking was under consideration, but the FOMC unanimously determined that a quarter-point hike was warranted and tolerable. There was some hope of what has been called a "dovish hike," which sounds like an oxymoron but means a hike with a promise of a pause. The statement and SEP gave no such promise. The statement suggested somewhat ambiguously that "some additional firming may be appropriate"— a modification from the prior meeting's statement that more explicitly called out the FOMC's expectation for some additional rate increases ahead.

Summary of Economic Projections (aka the Dot Plot):

The Fed releases its forecasts for its fed funds rate, inflation, unemployment and economic growth quarterly. These forecasts were largely unchanged from December. The expectation prior to recent events was that the forecasted end-of-year fed funds rate was going to be revised meaningfully upward. In the absence of clarity, it seems the survey participants fell back on their prior estimates, which indicated that fed funds would end this year between 5%-5.25% (one more hike). As it stands, the latest projections are in stark disagreement with fed funds futures market pricing, which expects cuts to happen over the course of this year. As of March 23rd, futures pricing puts a 72% chance of a rate cut during or before the July meeting.

Powell was quick to emphasize that policy will be determined by how the economic data actually unfolds, not how they expect it to unfold. What he was trying to do here is assert data dependency in a highly uncertain economic environment. So perhaps one could say, as Powell himself has suggested, that the disagreement in policy is actually attributable to a disagreement between the market and the Fed on the outlook for inflation.

The Press Conference:

For my money, all the good stuff happens in the Chair's press conference. That's when the markets really start to react as reporters try to dive into the Fed's thinking. The very first thing Powell said was that troubles in the banking sector were contained to a small number of banks. He would further go on to say that, if left unaddressed, those isolated problems would risk contagion to the broader banking sector, thereby justifying their extraordinary intervention. The biggest challenge for the Fed and markets to assess at this juncture will be the indirect impact of the episode in terms of credit impulse. In other words, how will this uncertainty impact banks' willingness to lend? With a heightened risk of deposit flight, banks are likely to tighten lending standards. This diminished willingness/ability to lend has Powell talking about how this credit contraction may do some of their inflation fighting job for them. The trouble is neither they, nor anyone else, has any idea exactly how much. Instead of predicting what future impact a contraction in bank lending will have, he fell back on what he knew about current conditions to color his outlook. Namely, inflation is too high and the labor market is too tight for them to back off just yet. Powell continued to cite the lack of progress in the non-housing services component of inflation and the outsized number of job vacancies relative to unemployed workers.

Market Reaction:

Bond markets rallied and stock markets sold off late in the day. The exact driver of these moves was obfuscated by simultaneous remarks from Treasury Secretary Janet Yellen, who was testifying to the Senate Appropriations Subcommittee. During that testimony, she said the FDIC was NOT considering blanket insurance for all bank deposits. Chances are that could have been a more likely catalyst for the equity market selloff than anything Powell said.

Main Takeaway:

The Fed is now juggling fighting inflation with ensuring financial stability. I've heard the metaphor that they are fighting two fires with one bucket of water. I don't necessarily agree that it's a straight tradeoff where they will have to sacrifice one to achieve the other. At some level, the threat of banking system instability indirectly complements the inflation fighting efforts of the Fed through tighter financial conditions, as mentioned above. Which is not to say the Fed welcomes financial instability, but they will undoubtedly get some inflation busting benefit from a fading credit impulse and need to recalibrate how they adjust monetary policy accordingly. On the other hand, the balancing act is fraught with peril given how uncertain the extent of the credit contraction will ultimately be. It's certainly far less manageable than monetary policy. Since the Fed is dead set on fighting inflation, I can only assume the odds of a so-called 'soft landing' have diminished considerably – a fact that the Fed Chair himself seemed to concede when asked about the potential outcome during the press conference.



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