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Federal Reserve Policy and Outlook

As of January 6th, 2022

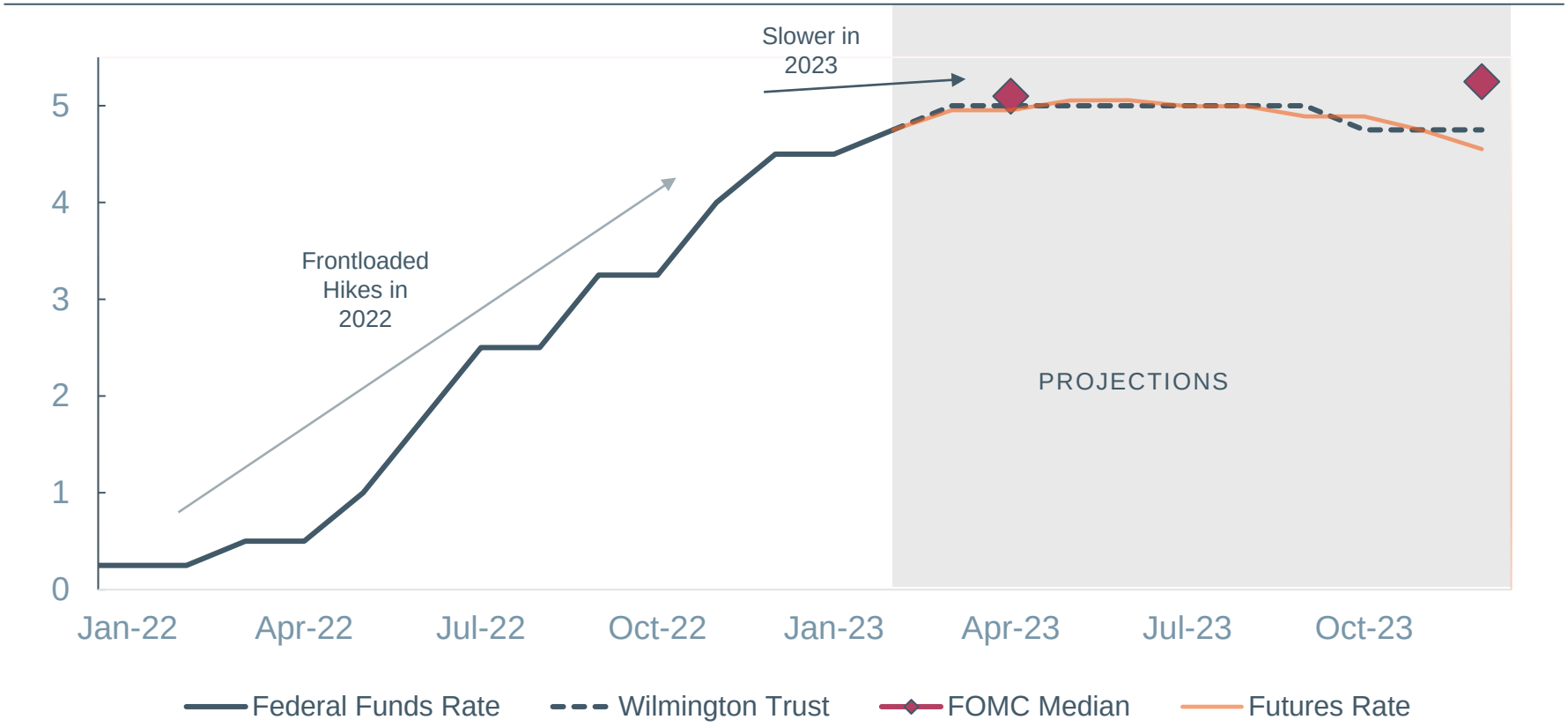
Key Takeaways

- At its February 1, 2023 meeting, the Fed slowed its pace of hikes to 25bp, bringing the target federal funds target range to 4.50%-4.75%.
- Chair Powell the committee's expectation for at least two more hikes and therefore a peak rate in excess of 5.00%. CPI readings between now and the next meeting in March will do much to inform the future path of policy. We'll receive comprehensive detail on projections from Powell and other FOMC members when the Summary of Economic Projections (SEP) is published next month.
- Chair Powell's commentary during the February press conference indicated more potential flexibility to the path of rates contingent on data. In particular, Powell did not shy away from the notion that a pause or even a cut could be on the table if inflation data comes in softer than expected. However, this was accompanied with hawkish language indicating that recent disinflation is still in too early of a stage to warrant consideration of a pause. Equity markets rallied pronouncedly, interpreting the Fed's signaled flexibility as a dovish shift.
- The Fed is also tightening policy via balance sheet reduction. Starting on June 1, 2022, they started to allow their Treasury holdings to passively decrease by $30 billion per month and Mortgage-Backed Securities (MBS) holdings to decrease by $17.5 billion per month. Those caps moved up to $60 billion and $35 billion, respectively, as of September 2022.
- We expect the Fed funds rate will peak at 4.75-5.0% following a 25bps hike at the March meeting and then pause just below the Fed's median projection.

Fed Policy vs. Market Expectations

The Fed “frontloaded” rate hikes in 2022 to swiftly bring interest rates into restrictive territory. The Fed has since moderated the pace of hikes to 25bps increments and raised the median projection for the federal funds target range to 5.0%-5.25% for 2023. We expect inflation to slow and for the federal funds target range to peak at 4.75%-5.0% March.

Federal Funds Rate (%, top of target range)

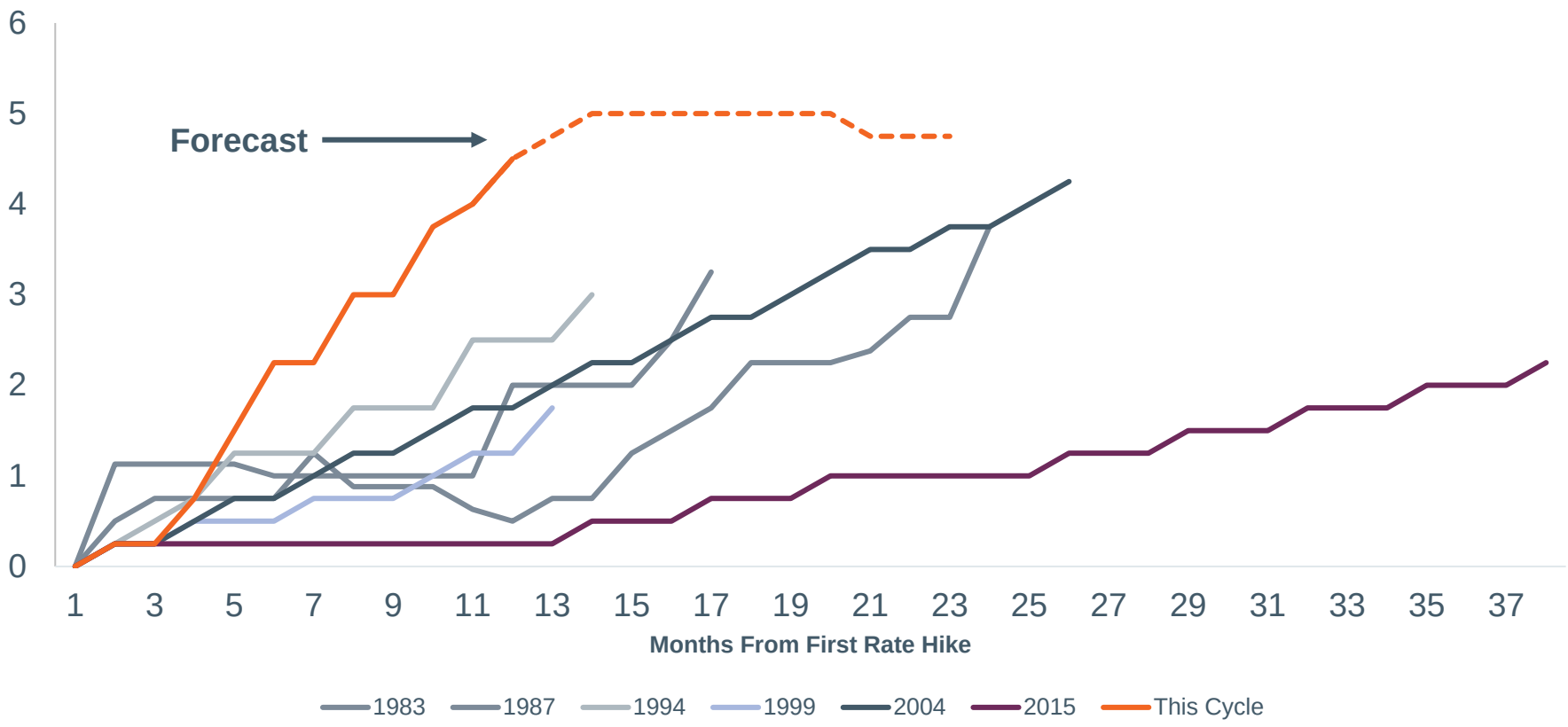


Data as of February 2, 2023. Sources: Macrobond, Federal Reserve, WTIA. A basis point is one hundredth of 1 percentage point.

The Most Aggressive Rate-Hike Cycle Since the 1970s

The Fed has tightened monetary policy at the fastest pace since the 1970s. We expect this degree of tightening—to persist until the Fed is convinced inflation has been controlled—will result in a mild recession in the second half of 2023.

Cumulative Change in Fed Funds Rate (%)

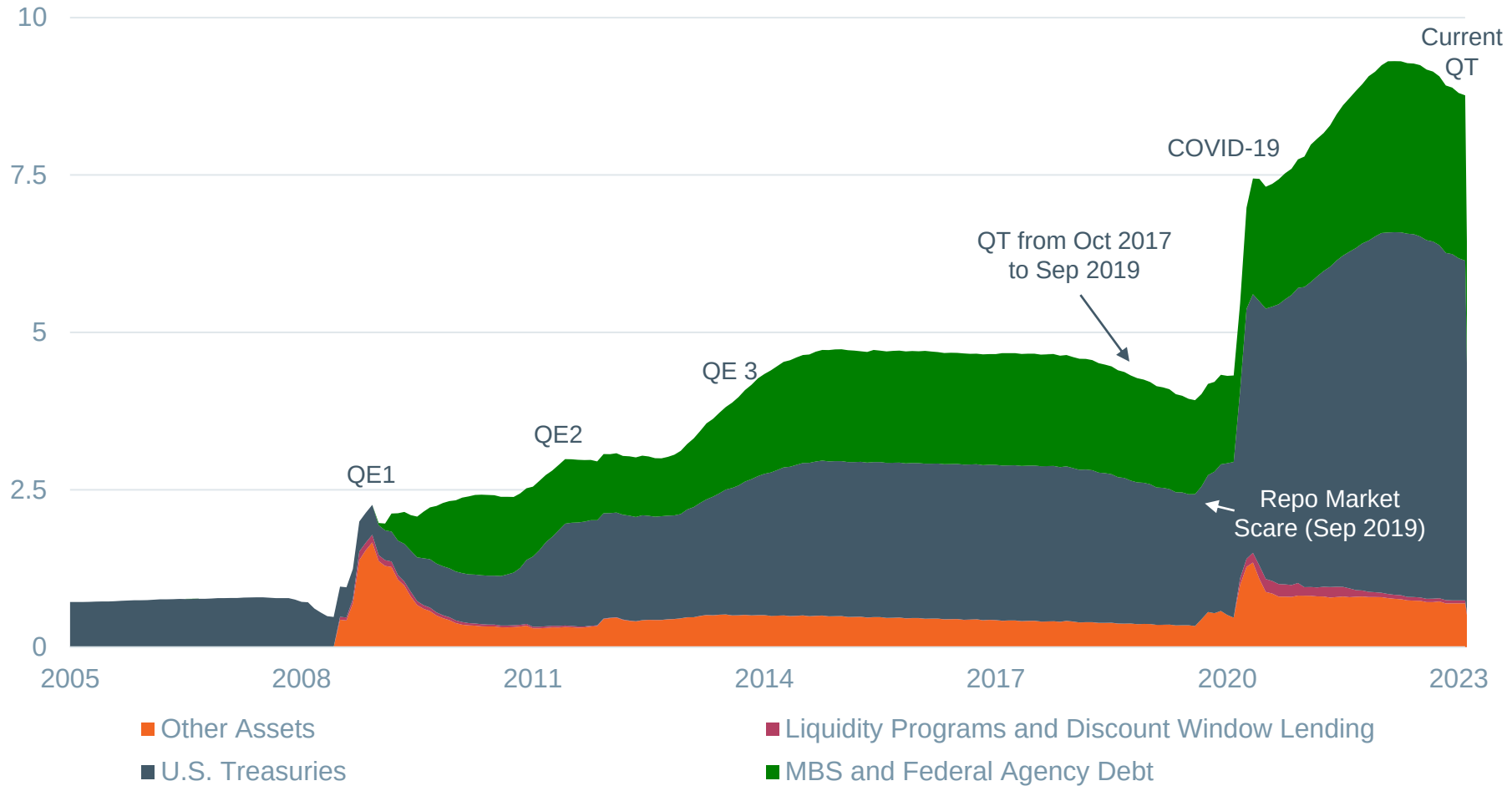


Data as of February 2, 2023. Sources: Bloomberg, WTIA.

Quantitative Easing and Tightening (QE & QT)

In June 2022, the Fed started to passively* allow its Treasury holdings to decrease by $30 billion per month and Mortgage-Backed Securities (MBS) holdings to decrease by $17.5 billion per month. Those caps were moved up to $60 billion and $35 billion, respectively, as of September 2022.

Federal Reserve balance sheet by selected assets ($ trillion)

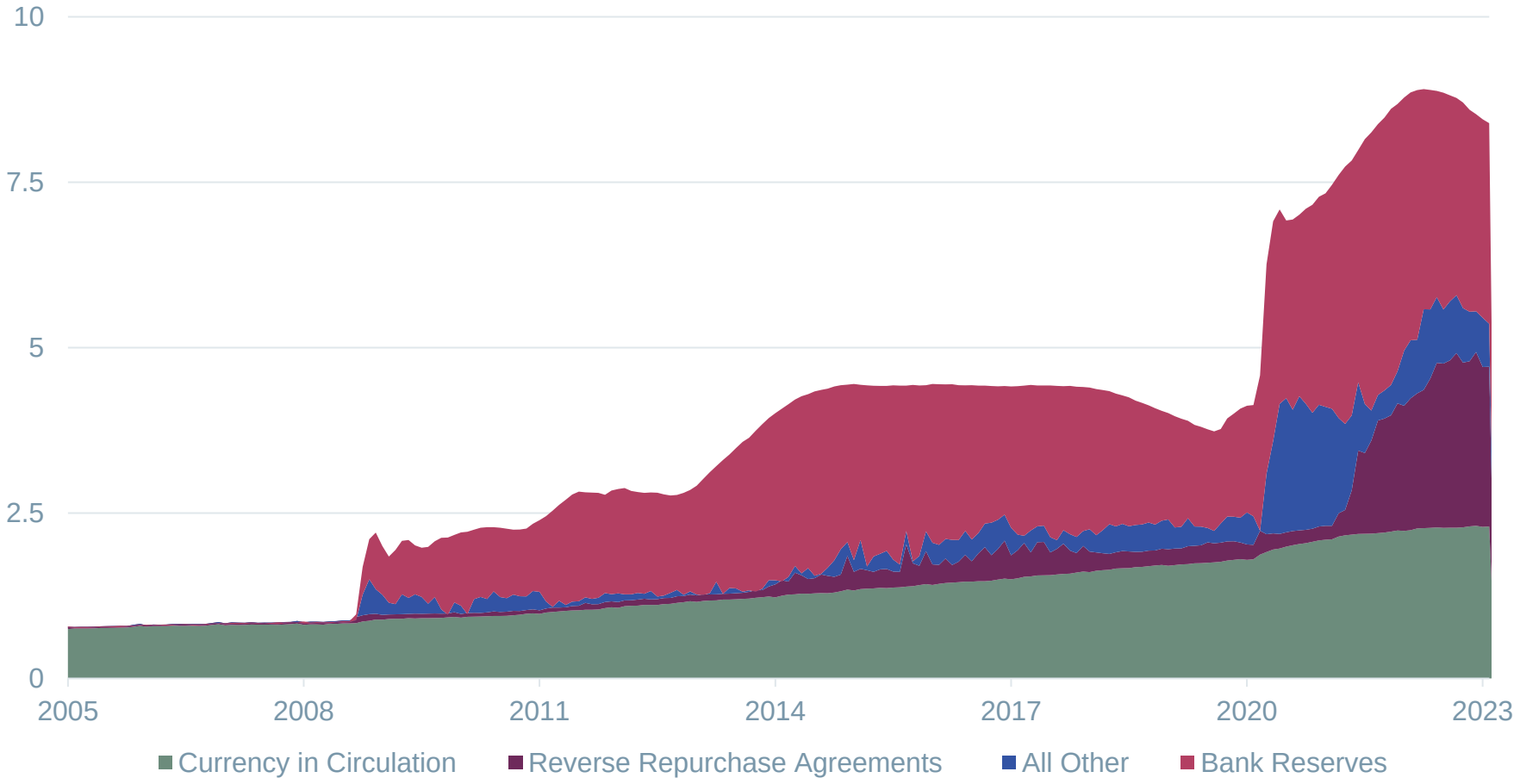


Data as of February 3, 2023. Sources: Federal Reserve, WTIA. *By passively, this means they are not selling securities. They have more than $30b of their Treasuries maturing each month and will reinvest all but $30b in June, for example. For MBS it's more complicated, because their holdings are not scheduled to mature. Instead, they rely on borrowers to pay back a mortgage early (when moving to a new home or refinancing, typically). Powell indicated there will likely be months when the MBS cap is not met, so their holdings will likely decline by less than the $17.5b and $35b caps in coming months.

Bank Reserves Falling Quickly as Intended

Commercial bank reserves in their accounts at the Federal reserve grew to a peak of $4.2 trillion by August 2021, up from $1.7 trillion before the pandemic. Concerns about these reserves making their way into the economy via loans, and fueling further inflation, contributed to the Fed's decision to implement balance sheet reduction starting in June 2022. Reserves have fallen more than $1.7 trillion from peak.

Federal Reserve balance sheet by selected liabilities ($ trillion)



Data as of February 6, 2023. Sources: Federal Reserve, WTIA. A reverse repurchase agreement is a short-term **agreement** to purchase securities in order to sell them back at a slightly higher price.

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