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BREAKING NEWS
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Facing heightened uncertainty, the Fed delivers another hike

The U.S. Federal Reserve hiked rates, as expected, at today's policy meeting. Uncertainty has increased since the last meeting. Though we expect at least one more hike this year, the Fed appears – for the first time this cycle – to be nearing the end of tightening.

Tony Rodriguez
Head of Fixed Income Strategy

WHAT HAPPENED?

The U.S. Federal Reserve continued its tightening cycle by hiking rates another 25 basis points (bps). That takes the target range for the policy rate to 4.75% - 5.00%, a fresh 16-year high.

Despite that hawkish headline, the rest of the meeting leaned significantly in the opposite, dovish direction. The policy statement now says that "some additional policy firming" will be needed, rather than the prior reference to "ongoing increases" in the policy rate. Notably, the Fed also used that language in 2006 to signal an impending pause in its rate hiking cycle.

Separately, there were no major changes to its macroeconomic projections. The median forecast is now for slightly higher inflation and slightly lower growth this year, but the terminal interest rate of 5.1% remains unchanged.

In his press conference, Chair Powell explained that he expects additional tightening will be needed. It remains to be seen if that tightening will come from higher policy rates or slower bank lending as a side-effect of the recent financial stress. Either way, the committee still sees lowering inflation as its principal near-term goal.

BANKING STRESS BALANCED BY GROWTH AND INFLATION

Since the Fed last met, markets have been hit by various gusts of bad news. Several U.S. banks failed, including the 16th-largest by deposits, and the ramifications remain uncertain. Contagion risks look low for now, thanks to the quick and forceful reaction from policymakers. Nevertheless, equities and other risk assets across the spectrum have weakened, giving back much of their rallies from earlier in January.

Despite the storm clouds hovering over the financial system, the latest economic data indicate nothing but clear skies. The labor market continues to create jobs at a blistering pace and surveys suggest improving sentiment. Income growth is strong as well, which should support future spending.

In fact, before the recent financial stresses, the principal risk was that the economic weather would remain too sunny for too long. Inflation continues to run hot, which, along with upward revisions to the 2022 figures, indicates that the inflationary trend has not substantively moderated in recent months.

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The economic and policy outlook remains highly uncertain in the current environment. We expect the U.S. financial system will avoid a deeper crisis, but lending conditions should tighten further. With inflation remaining a problem for the Fed, we expect at least one more rate hike later this year. These factors should combine to weigh further on growth in the quarters ahead. Though we do not see a hurricane on the horizon, 2023 will likely continue to see periodic squalls. Investors would be wise to pack an umbrella.

WHAT'S GOING TO WORK FOR INVESTORS?

Given the complicated economic and market backdrop, we don't expect a smooth ride, as several risks still loom large. While the interest rate outlook remains uncertain, the environment of ultra-low rates is clearly behind us. Inflation remains elevated. And we expect the global economy will slow.

We still think it makes sense to be selective with cyclicality and focus on quality across diversified portfolios. We emphasize dividend-paying equities as well as infrastructure investments that can weather a combination of slowing economic growth and volatile interest rates. Additionally, we like relatively higher quality areas across fixed income spread sectors.

Now may be a good time to consider taking profits in some areas and adding to risk in others. Many public market valuations have shifted noticeably so far this year. We continue to believe that investment grade fixed income, public REITs and investment grade municipal bonds offer compelling fundamentals, but all three have enjoyed strong rallies that have made valuations less compelling than they were at the start of the year. We also see opportunities to add some risk and beta to portfolios by focusing on emerging markets (particularly emerging markets equities). Additionally, we continue to like high yield municipals.

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

Endnotes

Sources

Federal Reserve Statement, March 2023.

Bloomberg, L.P.

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