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BREAKING NEWS
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The Fed hikes once more

The U.S. Federal Reserve hiked rates once again at today's policy meeting, as expected. Given the mixed economic backdrop and heightened downside risks, we think the tightening cycle is over for now, with the Fed set to keep rates on hold at the next several meetings.

Tony Rodriguez
Head of Fixed Income Strategy

WHAT HAPPENED?

The U.S. Federal Reserve continued, and likely finished, its tightening cycle by hiking rates another 25 basis points (bps). That takes the target range for the policy rate to 5.00% – 5.25%.

The Fed used its policy statement to signal an imminent end to this tightening cycle. It no longer "anticipates that some additional policy firming may be appropriate," instead saying that it will "closely monitor incoming information." The statement's new verbiage closely mirrors the text of the June 2006 statement, which marked the last hike of that tightening cycle.

In his press conference, Chair Powell leaned slightly hawkish, despite continuing to signal an end to rate hikes. He said that the Fed is "prepared to do more" if needed and will assess the incoming data on a meeting-by-meeting basis. Powell implied that more rate hikes could be warranted if inflation remains sticky and banking sector stresses moderate without further pain.

Nevertheless, the market continues to price in nearly three full rate cuts over the balance of this year, with zero additional hikes from current levels. When asked about the disconnect between Fed rhetoric and market pricing, Powell said that under the FOMC's projections it will not be appropriate to cut rates this year.

ECONOMIC BACKDROP IS STRONG BUT SOFTENING

In the six weeks since the Fed last met, economic data have been broadly positive. First quarter U.S. GDP growth disappointed in headline terms, at a +1.1% quarter-over-quarter seasonally adjusted annualized rate, but the details were strong. Most of the downside came from volatile inventories, which subtracted -2.3 percentage points from the headline number. The best gauge of underlying economic growth, final sales to private domestic purchasers, rebounded +2.9%, the fastest pace since early 2021.

Apart from the GDP numbers, other higher-frequency economic data have mostly been strong as well. The U.S. labor market continues to create jobs at a robust pace and consumer spending remains resilient. Manufacturing is one area of weakness, where conditions continue to soften and activity contracts.

Inflation has continued to run hot, and core PCE inflation accelerated in the first quarter. Additionally, wage inflation remains near recent highs. We expect both price and wage inflation to moderate over the rest of this year, but the persistence of upward pressures may undermine the case for the Fed to stop hiking rates.

These inflationary pressures are offset by continued uncertainty around the banking sector. Regional bank stocks are down around -31% since the end of February, which is likely to result in reduced lending. This trend will weigh on growth moving forward, doing some of the Fed's tightening job.

Ultimately, the economic backdrop combines both strong nominal growth and significant downside risks. We think the Fed will opt to keep rates on hold for the next several quarters as it gauges the impact of these shocks on the outlook for inflation and employment.

WHAT'S GOING TO WORK FOR INVESTORS?

With the Fed ending its rate hikes and the economic backdrop remaining uncertain, volatility will likely remain high. The good news is that, historically, market returns have tended to be healthy after the Fed paused rate hikes. Fixed income, where performance has been dragged down by rising rates, is likely to rebound broadly through the rest of this year as yields begin to decline more meaningfully.

We continue to favor an up-in-quality bias within fixed income sectors, where the risk-reward balance is most appealing. Some areas of the preferred and CMBS markets, which have weakened so far this year, are becoming attractive. Some areas of high yield municipals are attractive as well.

In equities, we believe investors should remain cautious. We favor defensive positioning, with an emphasis on infrastructure and dividend growth stocks. Both sectors tend to perform well during economic slowdowns and should be well-insulated from persistent inflation.

In private capital markets, we prefer allocating to income-producing asset classes with the potential for downside protection. In particular, we see compelling opportunities in select areas of private credit and private real estate.

A WORD ON THE DEBT CEILING

One wildcard in the market outlook is the U.S. debt ceiling. Congress has not yet raised the limit on federal borrowing, setting up a potential technical default this summer as bills become due and the Treasury's cash balance is run down.

We believe the most likely "x-date," when the debt limit will become binding and a technical default could be forced, will be in late-July or early-August.

Markets have begun to price in these risks, with Treasury bills becoming richer for maturities ahead of the x-date and cheapening somewhat for maturities around the x-date. But broader markets have not reacted materially.

We expect the debt ceiling to ultimately be raised ahead of the x-date, avoiding a technical default. However, the risks are real and may be higher than in prior debt ceiling showdowns. More volatility is likely as we approach the deadline. While it will challenge investors, it is highly unlikely to materially alter the broader outlook.

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

Endnotes

Sources

Federal Reserve Statement, May 2023.

Bloomberg, L.P.

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