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STRATEGY TEAM

EDGE RESEARCH INSIGHTS | June 15, 2023

The Federal Reserve Hits the Pause Button on Interest Rate Hikes

Key Facts

- In a widely anticipated and telegraphed move the Federal Reserve held interest rates steady Wednesday at the conclusion of its two-day meeting. The Fed kept its benchmark rate at 5% to 5.25%.
- This is the first time the Fed has not hiked rates since their tightening campaign began back in March of 2022 and has led to 500 bps of rate hikes over this time.
- However, despite the pause in hikes, the Fed signaled that they are prepared to raise rates two more times in 2023 and not cut rates until inflation comes down meaningfully and significantly.

Current Situation

With the Fed's decision to pause its rate hike cycle Wednesday, we have the first major policy deviation since the Fed initiated its hiking cycle back in March of 2022. The Fed initiated the hikes in response to inflationary pressures that began in the second half of 2021, which proved to be enduring rather than transitory as initially expected.

Throughout this period of rate hikes the Fed has maintained that its sole focus is to subdue inflation and keep it from getting imbedded into the market psyche. At the same time the market has continually maintained a more dovish outlook for Fed action. That disconnect was behind some of the investment losses in 2022 as the market seemed to be caught off guard by some of the more aggressive Fed actions, such as raising rates 75 bps at each of the June, July, September, and November 2022 meetings. That should have left no doubt that the Fed was solely focused on inflation regardless of the impact on stock and bond markets. But as we entered 2023 the market was still expecting the Fed to be in rate cutting mode by the end of the year.

More recently, however, the inflation data has shown some positive signs. Fed rate hikes often take time to work their way through the economic system, so there is a lag effect from when rates are raised and when the inflation data will cool. We're starting to see some of that now. Throughout the hiking cycle the economy has showed tremendous resilience as the jobs data continues to show high demand for labor and unemployment has stayed below 4% throughout. Recall, the Fed has a dual mandate: price stability (which they are attempting to control through the rate hikes meant to quell inflation) and full employment (a number considered to be about 4.5% in Fed models). With unemployment running closer to 3.5% during this period the Fed has the cover to focus solely on the price stability mandate and even at today's 3.7% unemployment rate there is slack in the employment market to allow the Fed to remain hyper-vigilant on driving inflation back down towards its 2% mandate.

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Fed Outlook

In addition to holding policy rates steady yesterday the Fed released a new dot plot (a graphic that shows where the Fed expects its policy rate to go) which revealed expectations for two more 25-point rate hikes by year end and no rate cuts until sometime later in 2024. Those rate hikes might be necessary. You can see in the chart below that the Fed still sees core inflation running above its 2% mandate until 2025. So, despite their efforts, there's still more work to do.

Core Inflation projections of Federal Reserve Governors and Reserve Bank presidents, Core Inflation[1]

Projection Date	2023	2024	2025
June 2023	3.7 to 4.2	2.5 to 3.1	2.0 to 2.4
March 2023	3.5 to 3.9	2.3 to 2.8	2.0 to 2.2

Source: The Federal Reserve

The Fed also released new economic projections for the first time since its March 2023 meeting. The Fed is now more optimistic on economic growth for the balance of 2023 (see chart below) while maintaining projections for 2024 and 2025. That's an indication that they believe that the rate hikes are working to reduce inflation but are not so severe that they push the economy into recession. In addition, the employment projections (see the second chart below) show the Fed's expectation for the unemployment rate in the coming years to stay within their full employment mandate.

GDP projections of Federal Reserve Governors and Reserve Bank presidents, Change in Real GDP[1]

Projection Date	2023	2024	2025
June 2023	0.7 to 1.2	0.9 to 1.5	1.6 to 2.0
March 2023	0.0 to 0.8	1.0 to 1.5	1.7 to 2.1

[1]Projections of change in real GDP and inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated.
Source: The Federal Reserve

Unemployment projections of Federal Reserve Governors and Reserve Bank presidents, Unemployment Rate[2]

Projection Date	2023	2024	2025
June 2023	4.0 to 4.3	4.3 to 4.6	4.3 to 4.6
March 2023	4.0 to 4.7	4.3 to 4.9	4.3 to 4.8

[2]Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.
Source: The Federal Reserve

Investment Outlook

The market had a difficult time initially assessing the Fed's action Wednesday as the pause in hikes was expected, but the dot plot showing two more hikes this year rather than one was unexpected and a rather bearish signal for markets. However, Chairman Powell's press conference calmed fears somewhat. Powell hedged that a hike wasn't already built in for July's meeting. Some market participants believe that with core CPI coming in at just 4% for May the Fed won't need to hike two more times this year. Still, it was an odd plan of attack for Powell—pause rate hikes but then signal that two more hikes are necessary, not one, because core inflation is stubbornly sticky. We think Powell does think the hikes are working and wants to give the system time to digest them all while at the same time maintaining a semblance of a hawkish tone in case inflation stops going lower.

Stock markets closed largely unchanged on Wednesday after an initial selloff but rallied strongly on Thursday as investors focused on the big picture—that rate hikes are coming to an end—rather than getting hung up on whether we'll experience one or two more. The Fed appears to be signaling that the end of this tightening cycle is rapidly approaching, and the markets appreciate the less hawkish tone. With inflation coming down and the economy remaining in expansionary territory, we think the conditions are positive for ongoing gains in the equity markets. While stock market gains through May of this year were heavily concentrated in just a handful of large cap tech stocks, the rally has broadened so far in June, and we believe with economic growth staying positive the rally can continue.

We believe that the Fed will take a backseat to corporate earnings as the main driver of continued stock market gains. Earnings in the second quarter were better than initial forecasts and expectations for the third quarter appear okay. We continue to favor Quality as a factor rather than speculative growth and don't want to pay up for stocks as valuations are fairly full. As the Fed stops hiking while other central banks around the globe continue to tighten, we expect to see opportunities for non-US equities to generate returns as the U.S. Dollar weakens. Within fixed income the yields offered on short term U.S. Treasuries remain very attractive, but as the rate hike cycle moves into the rearview mirror we would look to extend duration to capture upside if the rates available on three- and five-year notes move down.

If you have any questions, please reach out to your Edge advisor.

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