Federal Reserve Pivot Points
Past & Projected

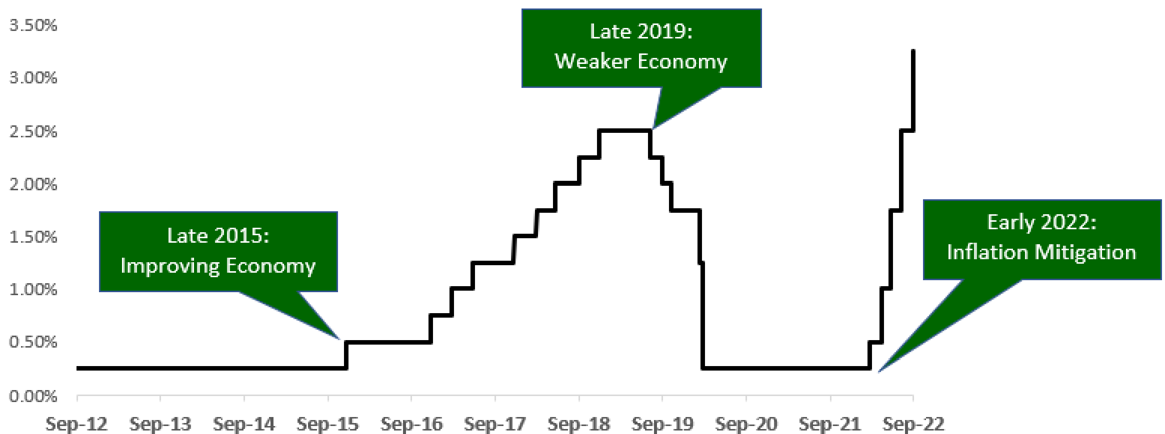
McQueen Financial Advisors

Inflation, rapidly rising interest rates, higher energy costs, employee shortages, and a potential recession. These are just some of the stress factors facing our industry. As we consider recent trends and try to make sense of an uncertain future, we find ourselves focused on the Federal Reserve Bank. This is because the Federal Reserve's broad goals are to promote maximum employment, stable prices, and moderate long-term interest rates. There are many policy tools available to the Fed. We will focus here on the Fed Funds rate trend and projections because fluctuating short-term rates impact many of our decisions and opportunities.

Federal Reserve Pivot Points

The Fed directly controls only one rate, the Fed Funds rate, or overnight rate. All other rates along the yield curve are determined by supply and demand. Changes to the Fed Funds rate typically happen on Federal Reserve meeting dates, about every 6 weeks. A pivot point is defined as the Federal Reserve moving from rate hikes to rate cuts or vice versa. Over the past 10 years, there have been only 3 pivot points.

"Boost rates several more times"



Consistent with the dual mandate of low inflation and stable labor markets, the Fed is currently much more focused on inflation. They are expected to boost rates several more times which may result in slower growth or recession. Eventually, we are likely to see weakness in the labor market. In their September 2022 release, the Fed projected that the unemployment rate would increase slowly, reaching 4.4% by the end of 2024. As long as labor markets continue to perform reasonably well, the Fed is likely to increase the Fed Funds rate to address inflation issues. It's early in the rate cycle. So far, employment has been strong, hiring is challenging, and wages continue to rise. If the trend reverses, the Fed won't ignore slower labor market conditions. Assuming inflation pressures are under control, weaker labor markets will lead to the next pivot point for the Fed to begin lowering rates.

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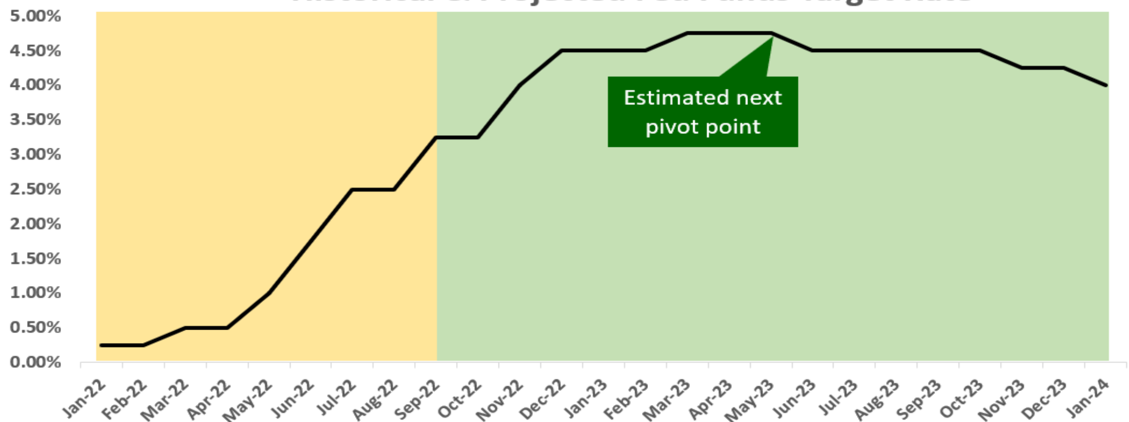
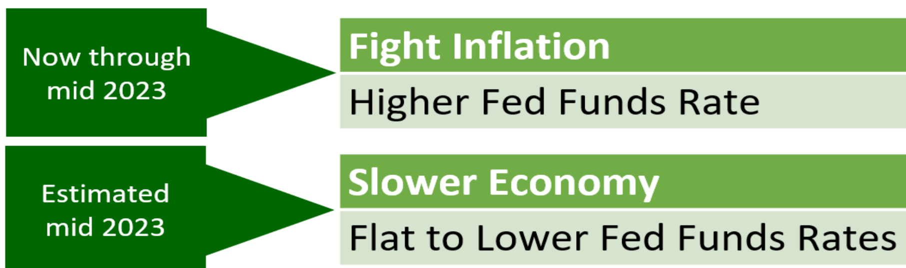
The Next Pivot Point
It is widely expected that the Fed will continue rate hikes in their effort to reduce inflation. The next pivot point (lower rates) therefore won't happen until inflation is under control. Moving from a period of rate hikes to a pause or a pivot to rate cuts will require either significant deterioration in the labor markets and/or economic weakness. In this rate cycle, we have not yet seen deterioration in the labor market and only some signs of slower economic conditions. Once the Fed gets where they want to be on inflation, they will likely maintain rates at a high level for some period. The Fed tends to be aggressive in hiking rates until we see inflation numbers come down. This will be followed by a wait-and-see period before rates trend lower. As shown in the section below, the next pivot point is currently expected sometime in mid to late 2023.

Projections
Forecasting the Fed Funds rate accurately is challenging. We know from experience that the timing and severity of future rate changes can not be known with certainty. The Federal Reserve regularly publishes rate forecasts, then adjusts them higher or lower nearly every quarter. We often review the Fed Funds futures market, which reflects the collective marketplace insight regarding the potential course of the Fed Funds rate. It's not perfect, but this is the best indicator we have. The Fed Funds futures market indicates that the Fed will continue to raise rates until early to mid 2023 with rates topping out at 4.75%. Thereafter, the rate is projected to remain unchanged for a brief period before falling. These forecasts were prepared after the Fed's September 2022 rate hike.

"Rates topping out at 4.75%"





Timing
Each quarter, the Fed releases projected GDP, unemployment rates, and inflation estimates. Based on their current and planned actions, the Fed expects that GDP and inflation will revert to 'normal' levels by the end of 2023 or early 2024. If these levels are achieved, we can expect at a minimum that the pace of Fed rate increases will slow or that rates will begin to drop.

End of Year>	2022	2023	2024	2025
Change in Real GDP	0.2%	1.2%	1.7%	1.8%
Unemployment Rate	3.8%	4.4%	4.4%	4.3%
PCE Inflation	5.4%	2.8%	2.3%	2.0%

Action Steps

- Don't attempt to time the market. The estimates in this report can't be relied upon with certainty. Markets are volatile and we know that investment rates often change in anticipation of Fed actions.
- Avoid callable bonds. Callable bonds may provide a moderately higher yield than non-callable bonds, but the issuer will call them if interest rates trend lower. The extra yield available on callable bonds rarely compensates for the risk of early redemption.
- Build a diversified investment ladder. Waiting for the best rate environment is rarely successful because it's impossible to know if rates will trend higher or lower.
- Keep an eye on the yield curve, because an inverted curve is typically followed by a recession and lower interest rates.
- Closely review and understand asset liability management stress tests. Short-term interest rates have already increased at a pace not seen since the 1990s and will likely trend higher. In effect, we are in the middle of a rate shock. These tests can tell us a lot about risk to income and value.
- Run ALM simulations. McQueen's 24/7 On-Demand ALM Simulator is a valuable tool that can be used to measure the impact of planned growth, budgets, or unplanned events. Running a simulation takes only minutes.
- Carefully review funding needs and deposit rates. Rapidly rising short-term rates may cause depositors to demand higher savings and CD rates. Deposit rates should be increased only in response to the need for funds, not solely on competition.
- Raise loan rates. Mortgage rates are closely tied to benchmark U.S. Treasury rates and have already increased. All other rates should be reviewed and increased as appropriate.
- Review risk-based loan pricing grids. In times of economic uncertainty, it is important to protect earnings and capital. An economic downturn may result in higher delinquency and charge-offs. Consider the risk/reward of lower tier borrowers.
- Seek outside advice. We are in a period of uncertainty not seen in nearly 40 years when most of us were not in leadership positions. In times of uncertainty, it makes sense to seek the advice of McQueen's investment, ALM & CECL professionals who can help interpret markets and provide valuable insight.

"Seek outside advice"