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SKY Harbor Weekly Briefing

On the Precipice of a Pause

As expected, the Federal Reserve raised interest rates by 25 bps at the May FOMC meeting, their 10th consecutive hike in just over a year. Though Chairman Powell stopped short of announcing a pause, key changes in the released policy statement (removal of the word "anticipating" in relation to future additional increases) gave investors hope that tightening may be at an end. In this *Weekly Briefing*, we highlight the extraordinary pace of rate hikes this cycle, with a focus on economic implications stemming from the Fed's desire to further cool inflation.

"We're Getting Close, Or Maybe Even There"

Though investors largely anticipated Wednesday's decision – which was unanimous among committee members – several former Fed officials and market pundits voiced their preference for a pause in the days leading up to the meeting. Arguing that another 25 bps of tightening was not necessary, **dissenters pointed to the "long and variable" lag between monetary policy action and the ultimate impact on the economy**, particularly in light of how much the Fed has moved in recent months. Also of concern is continued strain from the banking crisis, which is expected to further constrict credit even in the absence of additional issues arising from the regionals. **Supporters of the hike highlighted still elevated prices and a hot labor market amidst economic resilience, focusing instead on the risks from prematurely declaring victory on inflation.** Ultimately, though the Chairman stopped short of announcing a pause in the hiking cycle (noting that decisions will continue to be made on a "meeting-by-meeting" basis), futures markets have moved aggressively to price in cuts beginning this September.

FOMC Hikes Despite Cautious Tone from Former Members
select commentary, pre- and post-FOMC decision

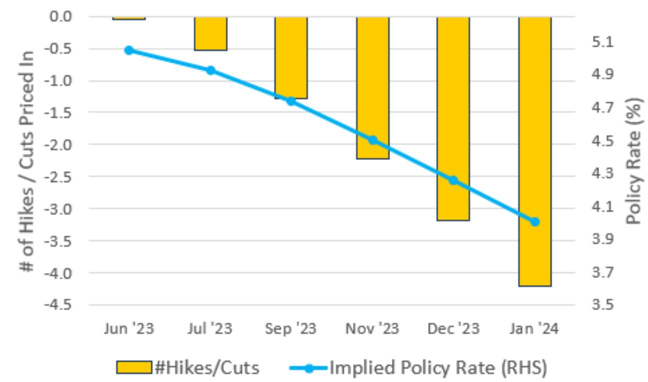
"My own view is that the economy is quite likely to slow down in the second half of the year, and that its not necessary at this point to be raising rates until we get a better view of what the second half of the year looks like." **-Fmr Boston Fed President Rosengren**

"I would be in the camp of signaling a pause," citing significant hikes thus far and tighter credit stemming from the banking crisis. **-Fmr Fed Vice Chair Clarida**

"I'd prefer to do what's called the hawkish pause, not raise but signal that we are in a tightening stance, because I actually think the banking situation may well be more serious than we currently understand." **-Fmr Dallas Fed President Kaplan**

Following the unanimous decision to raise rates by 25 bps, **Fed Chairman Powell** noted that "We feel like we're getting close, or maybe even there," referring to future rate hikes needed to reduce inflation.

Markets See Next Move as a Cut
Fed funds futures implied rate by FOMC meeting date, as of May 3, 2023

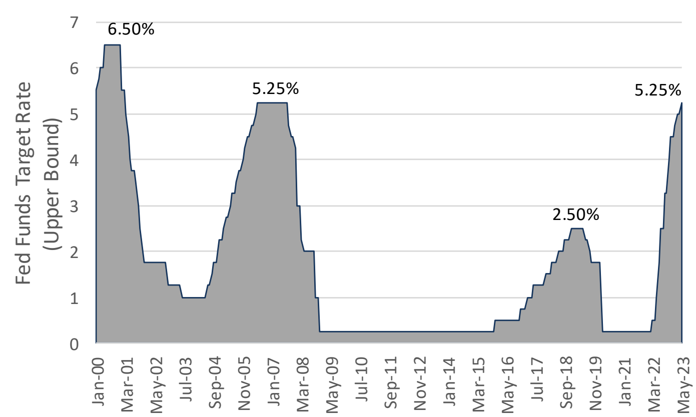


Source: SKY Harbor, Federal Reserve, Bloomberg

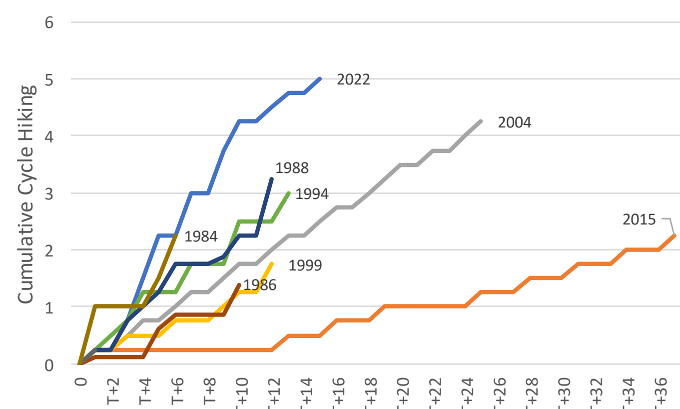
A Torrid Pace

Following a May hike, the upper bound of the Federal Funds Target Rate has reached 5.25%, its highest level since 2007. Perhaps more impactful, **the pace of rate hikes – 500 bps in just over a year – is somewhat extraordinary, representing the most aggressive cadence in approximately four decades**. Though perhaps merited given the rise of inflation in the post-pandemic period, rapid hikes can lead to unintended consequences, with cracks already emerging in the form of bank stress. On that topic, and despite Powell's insistence that issues stemming from three banks "at the heart of the stress" have now "been resolved," he did concede that it may take months before the full impact policy action and tightening lending standards have on the economy will be fully understood.

Fed Funds Rate Now Highest Since '07
monthly data, since Jan 2000



Steepest Hiking Cycle in Decades
by hiking cycle, month "0" precedes first hike



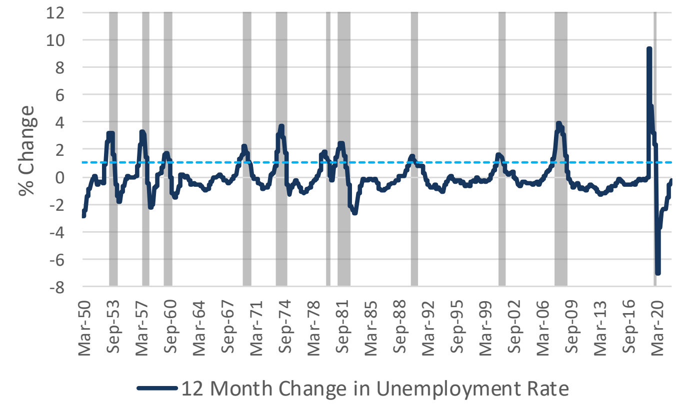
Source: SKY Harbor, Federal Reserve, Bloomberg

"We are Prepared to Do More"

Powell was clear that, despite aggressive actions taken to date, inflation remains too high and that convergence toward a more normalized environment will take time. As such, the Chairman continued to characterize rate cuts in the back half of 2023 as unlikely despite market signals to the contrary. At issue is a still overheated job market with an unemployment rate of 3.4%, a level that has stubbornly remained over 100 bps below the Fed's projection by year end. **Looking back at data since 1950, we highlight below 11 periods in which the unemployment rate increased by at least one percentage point over a 12-month period**. Unfortunately, each one coincided with a recession, a dynamic not lost on politicians who fear the Fed's quest to kill inflation will result in millions of job losses and negative output growth.

Rising Unemployment Correlated w/ Shrinking Output
quarterly data, since 1950

Recession Has Followed 1% Increases in Unemployment Rate
monthly data, recessions shaded grey



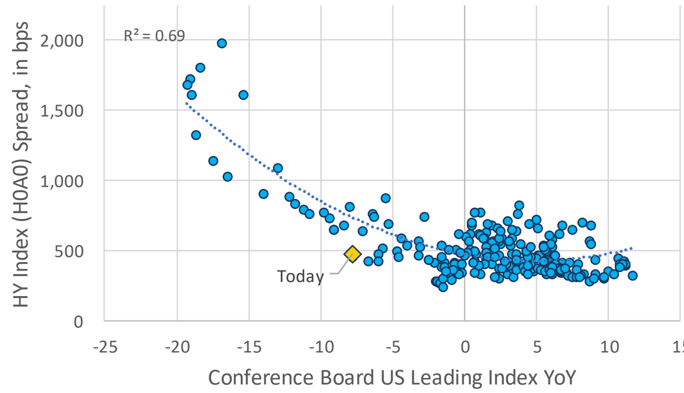
Source: SKY Harbor, The National Bureau of Economic Research, Bloomberg

So You're Saying There's a Chance…

Acknowledging that such an outcome would go against historical precedent, Powell noted that "it's possible that we can continue to have a cooling in the labor market without having the big increase in unemployment" observed in prior episodes, and even went on to say that **"the case of avoiding a recession is, in my view, more likely than that of having a recession."** Though no doubt reassuring to hear the Fed Chairman's optimism, and keeping in mind that high-single digit annualized high yield index returns have historically been generated in months that follow the final hike of a monetary tightening cycle (see our *Weekly Briefing* entitled The Final Hike? for additional details), several leading economic indicators are trending in the wrong direction. More specifically, weakening of consumer expectations for business conditions, softening ISM Index new orders, and lower building permits make **high yield index spreads appear tight relative to historical correlations with The Conference Board Leading Index**. Importantly, however, a meaningful decline in high yield bond prices may not be necessary to correct the divergence illustrated in the scatterplot below. Rather, an underlying rally in rates, consistent with what happened in two of the previous three hiking cycle transition periods, could push spreads sufficiently wider without much added stress on secondary market trading levels.

Leading Economic Indicators Trending Down
monthly data, recessions shaded grey

Spreads Appear Tight Given Leading Indicator Trends
monthly data, trailing 20 years



Source: SKY Harbor, Conference Board, NBER, ICE Data Indices

Remain Defensive

Reiterating thoughts expressed in prior *Weekly Briefings*, we remain cautiously optimistic about high yield in 2023, with our view that spreads may need to widen offset by attractive starting yield-to-worst levels. We do, however, expect market volatility to pick up in the coming months, in our view driven by the hard vs. soft landing debate and an evolving earnings growth narrative. As such, we continue to believe default and downgrade avoidance will be paramount this year, and thus maintain our more defensive portfolio construction with an emphasis on credits expected to demonstrate muted earnings cyclicality in the coming quarters.

Important Disclosures and Disclaimers