Commentary

Money Markets

Federal Reserve remains hawkish on interest rates amid fears of a looming recession

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KEY TAKEAWAYS

- To combat unacceptably high levels of inflation, the Federal Reserve is expected to continue to tighten monetary policy in 2023—albeit in smaller increments—and maintain higher policy rates for an extended time.
- The Fed raised the federal funds rate by 425 basis points in 2022, taking the target range to 4.25%–4.50%. In February, the central bank lifted the benchmark rate by another quarter percentage point.
- Inflation pressures are beginning to show signs of easing, while U.S. growth is likely to decline in 2023.
- A resolution to the debt ceiling is expected to meaningfully increase the supply of Treasury bills.
- Money market flows trended higher through the end of 2022, buoyed by further interest rate hikes and market volatility.

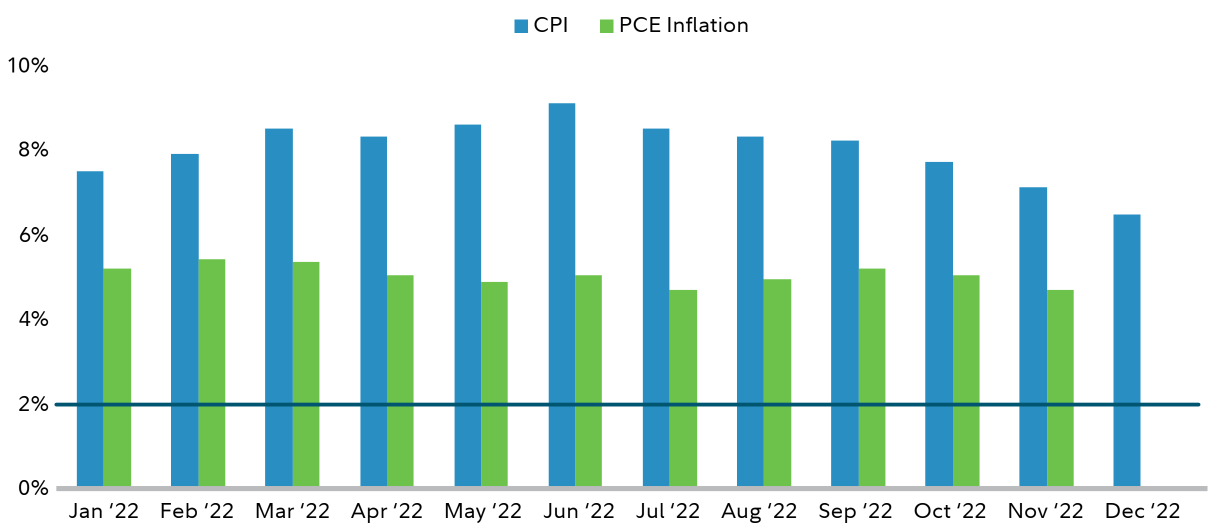
Fed remains cautious on inflation and against "prematurely" pivoting from higher rates

A series of rate hikes by the Federal Reserve in 2022 has left the benchmark federal funds rate in a target range of 4.25%–4.50%.[1] In December, the central bank raised its policy rate by 50 basis points, moderating the pace of increases after four consecutive 75 basis-point moves. At their first meeting in 2023, policymakers lifted the policy rate by 25 basis points to a range between 4.50% to 4.75%, the highest level since 2007. Still, the Fed has signaled plans to continue to tighten monetary policy and maintain a higher level of interest rates for longer than current market pricing suggests. Fed Chair Jerome Powell has said that long-term inflation expectations need to be "well-anchored," and that the "historical record cautions strongly against prematurely loosening policy."

The Federal Open Market Committee (FOMC) continues to reiterate its commitment to achieve maximum employment and bring inflation back to its 2% target.[2] In recent weeks, some members of the FOMC have discussed a further moderation in the pace of rate hikes, while suggesting that rates will need to remain sufficiently restrictive for some time to ensure that inflation returns to 2% on a sustained basis.

How inflation and the labor market react to Fed policy changes already in place will help determine the trajectory of rates going forward. U.S. inflation continued to ease into the end of 2022. While the consumer price index (CPI) rose 6.5% in December compared with a year earlier, it marked the sixth straight monthly deceleration from a peak of 9.1% in June.[3] CPI in December fell 0.1% from the prior month, the first decline in two-and-a-half years. Core CPI, which excludes volatile food and energy components, rose 0.3% from the prior month and 5.7% from a year ago. In addition, the Fed's preferred inflation measure—the personal consumption expenditures (PCE) price index, excluding food and energy—rose 0.2% in November from a month earlier and 4.7% from a year earlier, easing from a gain of 5% in October[4] (Exhibit 1). Taken together, the readings point to price increases moderating in key goods and services. Still, resilient consumer demand—particularly for services—paired with a strong labor market, will likely keep inflation above target for an extended period.

EXHIBIT 1: The consumer price index (CPI) and the personal consumption expenditures (PCE) price index remain higher than the Fed's 2% target inflation rate.



Source: Federal Reserve and Bloomberg Finance L.P., as of Dec. 31, 2022. PCE inflation was not available for December 2022.

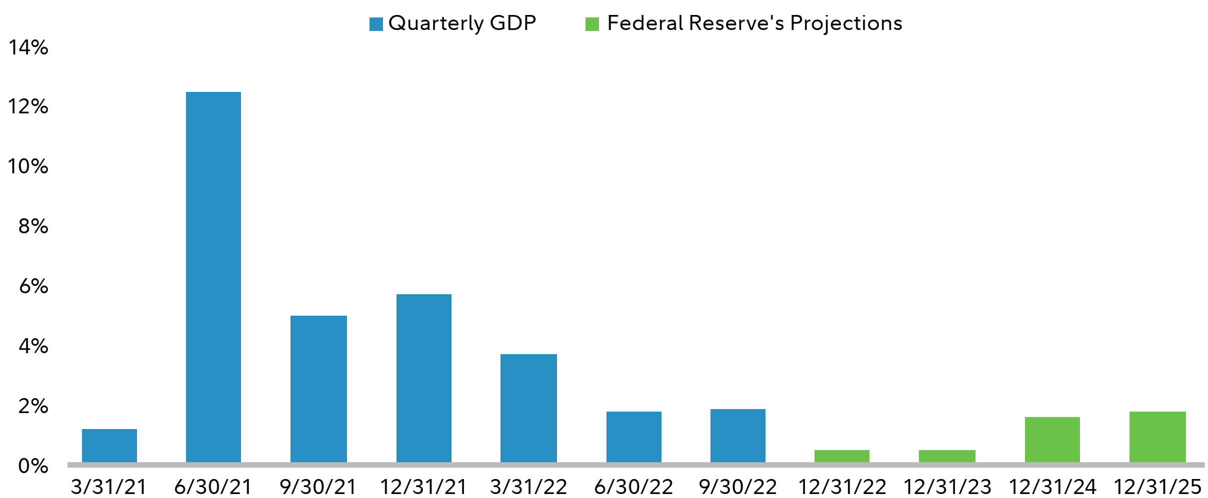
Global economies face headwinds and U.S. GDP growth set to slow

The World Bank cut its global growth forecast, warning that new adverse shocks could tip the global economy into a recession. Global gross domestic product (GDP) is expected to increase 1.7% in 2023 from 3% forecast in June, the Washington-based lender said. The bank, which also cut its growth estimates for 2024, said elevated inflation, higher interest rates, reduced investment, and disruptions caused by Russia's invasion of Ukraine are to blame for the sharp downturn. Meanwhile in the U.S., the Fed expects growth to be much weaker in 2023 than previously forecast. Real GDP growth expectations were 0.5% in December, down from 1.2% in the projections released in September. The economy is expected to grow 1.6% in 2024 and 1.8% in 2025, according to the Fed's summary of economic projections in December (Exhibit 2).

Amid the gloomy outlook, third-quarter GDP growth was higher than previously estimated, reflecting upward revisions to consumer spending and business investment. Real GDP increased at an annual rate of 3.2% rate during the period, from a previously reported 2.9%, according to the Commerce Department in December. Personal consumption rose 2.3% from an earlier estimate of 1.7%. A strong labor market and wage growth have underpinned household spending, but it remains uncertain this momentum will continue in 2023 amid higher rates. In addition, deteriorating sentiment among small-business owners, along with contractions in the Institute for Supply Management's gauges of services and manufacturing, signals a material shift in economic conditions. The fear in the market is that the Fed's aggressive tightening will ultimately result in a rise in the unemployment rate and push the economy into a recession.

EXHIBIT 2: The U.S. economy is forecast to slow as interest rates trend higher.

GDP % Change



Source: Federal Reserve and Bloomberg Finance L.P., as of Dec. 31, 2022.

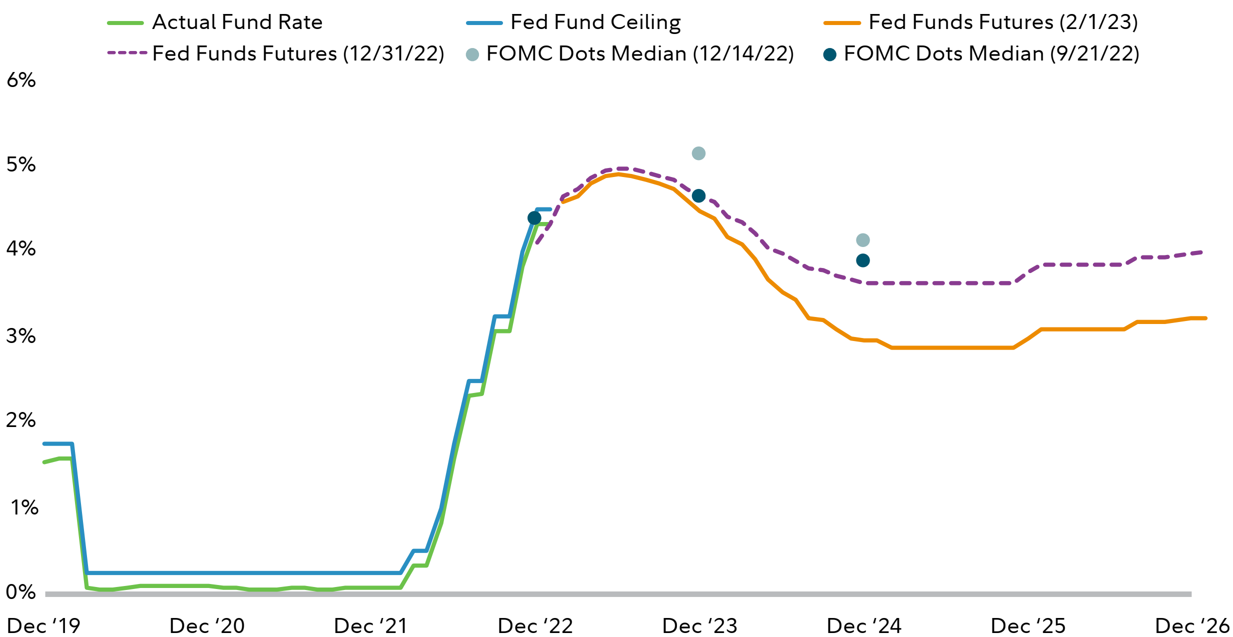
Job growth remained robust, wage gains cooled, and the unemployment rate ticked lower to 3.5% in December. Employers added 223,000 jobs in December on a seasonally adjusted basis, the Labor Department said. Wage growth (average hourly earnings) eased to 4.6% from a year ago. A sustained deceleration in wage growth could offer some comfort to central bank officials that a key driver of the inflation is losing steam. Fed officials regard wage pressures as a key hurdle to achieving their 2% inflation goal. The data underscores both the enduring strength of the job market and how a persistent imbalance between the supply and demand for labor is keeping upward pressure on inflation. That said, the uptick in the labor force participation rates and the slowdown in wage growth suggest some of the tightness in the labor market is starting to unwind. The participation rate—the share of the population that is working or looking for work—ticked up to 62.3%, and the rate for workers aged 25–54 rose.

Against this backdrop, we expect the Fed to raise interest rates further before pausing to assess how the most aggressive tightening cycle in decades is impacting the economy. The December jobs report offered a best case scenario for the Fed—Americans keep their jobs as inflationary pressures of earnings ease—giving policymakers room to slow the pace of interest rate hikes.

There has been renewed market discussion in recent weeks on the size of the Fed's rate moves over the near term. Recent comments from Fed officials seem to converge toward 25 basis-point increments instead of 50 basis-point hikes. Federal Reserve Bank of Philadelphia President Patrick Harker, who will be a voting member of the FOMC, indicated a preference for 25 basis-point hikes going forward as well. In their December summary of economic projections, Fed officials on average expect to raise their policy rate as high as 5.1% by the end of 2023, before lowering the rate to 4.1% by the end of 2024[4] (Exhibit 3).

EXHIBIT 3: The Fed's latest projections suggest the fed funds rate will end this year at 5.1%, while the market is pricing in rate cuts in the second half of 2023.

Fed Funds Futures vs. Fed Funds Rate



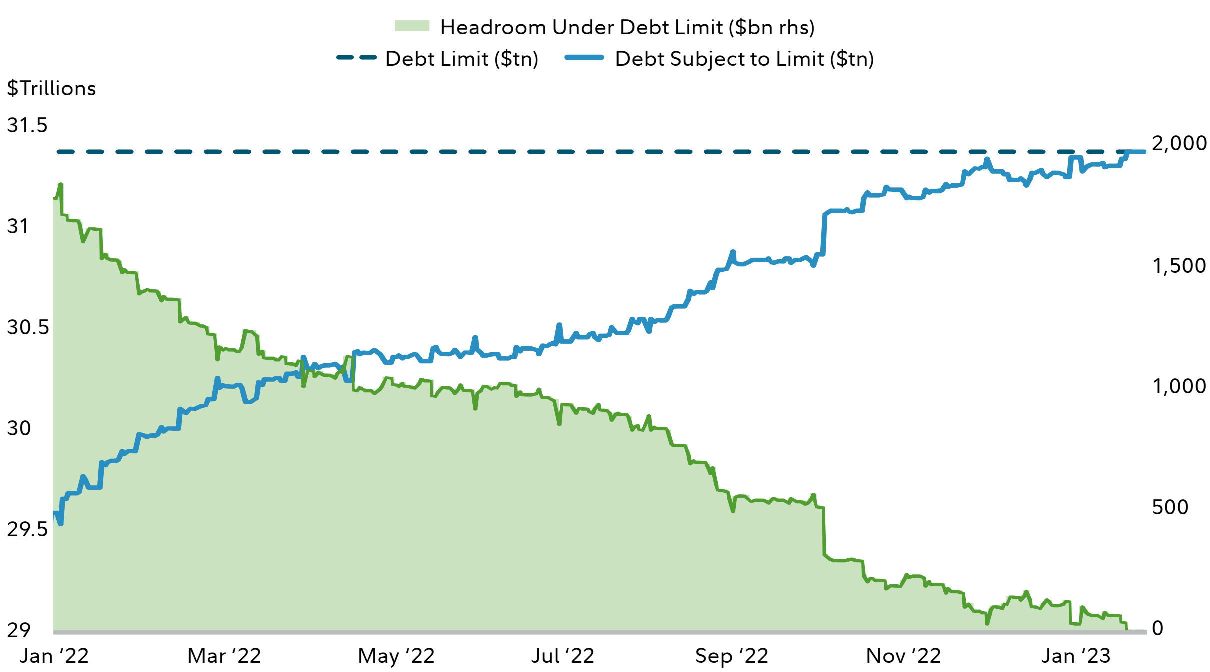
Source: Federal Reserve and Bloomberg Finance L.P., as of Feb. 2, 2023.

A resolution to the debt ceiling showdown could boost Treasury bill issuance

The debt ceiling is the legal limit on the total amount of federal debt the government can accrue. The limit applies to almost all federal debt, including the roughly $24.3 trillion of debt held by the public and the roughly $6.9 trillion the government owes itself because of borrowing from various government accounts, such as the Social Security and Medicare trust funds.

The federal debt ceiling was last raised in December 2021 by $2.5 trillion to $31.381 trillion. The U.S. reached this borrowing cap, which was expected to last until July 2023, on January 19. As a result, the Treasury Department must manage debt issuance and use its general account balances to remain under the ceiling. The Treasury has started using accounting tools at their disposal, called "extraordinary measures," to avoid a default and to rebuild its cash balance to a more comfortable level. This enables the Treasury to temporarily increase bill supply to help fund tax refunds ahead of the large tax receipts expected in April. Once these measures are exhausted to fund the U.S. government, a new congressional agreement will be needed to either raise or suspend the debt ceiling.

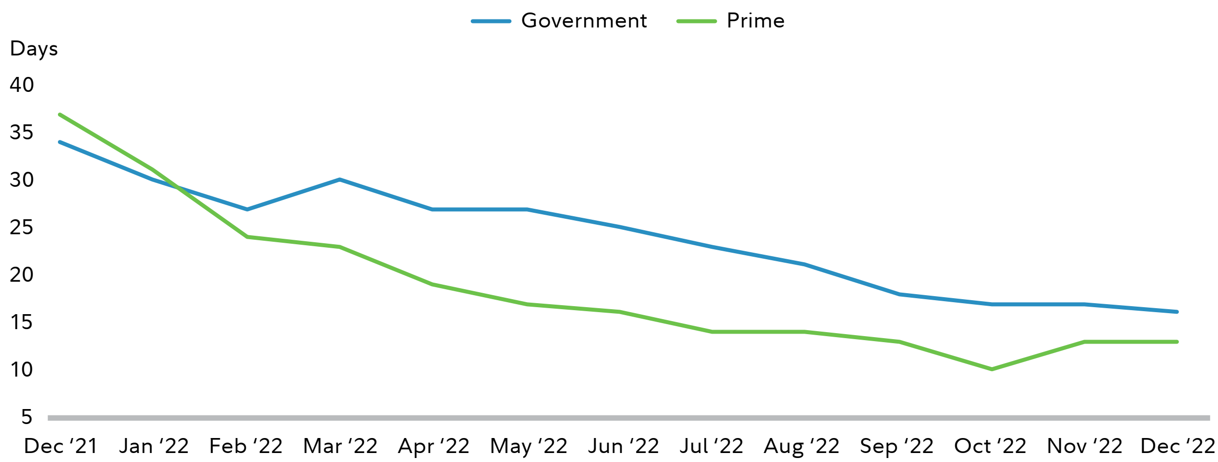
EXHIBIT 4: The U.S. has reached the technical debt limit, prompting the Treasury Department to use "extraordinary" measures.



Source: Haver Analytics and Fidelity Investments, as of Jan. 25, 2023.

The question remains when Congress will raise the debt ceiling because of ongoing political divisions among lawmakers. Once the debt ceiling is lifted, an estimated $1 trillion of bill issuance will shift the supply imbalance and may create an opportunity for money market investors to buy bills at more attractive levels. The rising supply may coincide with money market fund managers' willingness to extend portfolio maturities beyond their current record-low weighted average maturities (WAMs) (Exhibit 5).

EXHIBIT 5: Weighted average maturities for taxable money market funds.



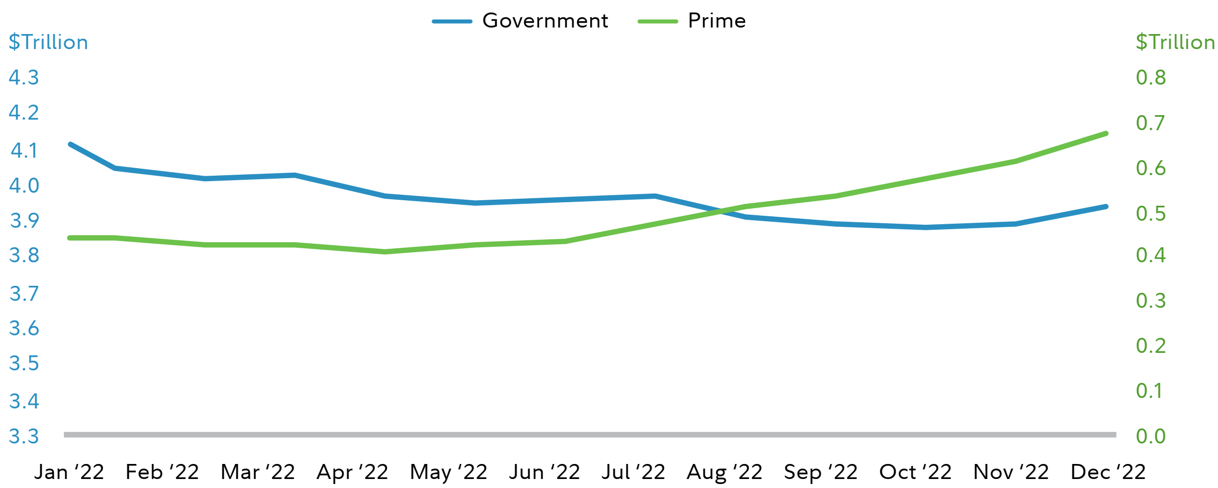
Source: iMoneyNet, as of Dec. 31, 2022.

Money market funds continued to attract inflows

Money market flows trended higher through the end of 2022 as investors shifted from risk assets, such as equities and bonds, amid rising market volatility and interest rates. Much of the increase was driven by retail investors' preference for prime money market funds (Exhibit 6). Total assets in prime money market funds have steadily increased since mid-2022 as retail investors have found these yields more attractive as the Fed continues with its hiking cycle. Still, this trend in flows into prime money market funds could slow or reverse as market participants reallocate to riskier investments once the tightening cycle passes. Meanwhile, total assets in government money market mutual funds reached about $4.0 trillion as of December 31.

EXHIBIT 6: Retail investors have driven flows into prime money market funds.

Government vs. Prime Assets under Management



Source: iMoneyNet, as of Dec. 31, 2022.

Prime money market funds took advantage of the additional supply at attractive spreads as banks extended their liabilities over year-end. As a result, prime money market funds extend their weighted average maturities in December, while government funds continued to shorten their portfolios. Overall, government and prime funds' WAMs registered 8.9 days (-3.3 days month-on-month) and 14.9 days (+2.5 days month-on-month) at year-end, respectively. Government money market funds reduced their exposure to Treasury bills and repos in December, investing $220 billion more in the Fed's overnight reverse repurchase agreement facility (RRP) from the previous month. Meanwhile, prime money market funds invested approximately $100 billion more in the RRP in December from November, shifting money out of bank time deposits, Treasuries, and agency debt. As a result, the RRP hit a record of $2.55 trillion at the end of 2022. Money market funds made up about 91% of the total size placed with the central bank.

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Kerry Pope is an institutional portfolio manager in the Fixed Income division at Fidelity Investments. In this role, he is responsible for communicating portfolio strategy and positioning, designing customized liquidity management solutions for institutional clients, and providing portfolio reviews.

Fidelity Thought Leadership Vice President Shanthy Nambiar provided editorial direction for this article.

[1] Federal Reserve, Dec. 31, 2022. https://www.federalreserve.gov/monetarypolicy/openmarket.htm

[2] Federal Reserve Board, Dec. 14, 2022. https://www.federalreserve.gov/newsevents/pressreleases/monetary20221214a.htm

[3] Bureau of Labor Statistics, Jan. 12, 2023. https://www.bls.gov/news.release/cpi.nr0.htm

[4] Federal Reserve Board, Dec. 14, 2022. https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20221214.pdf

All information as of Jan. 30, 2023, unless otherwise noted.

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