No Cuts

Avalan Continues to Expect the Fed Fund Target Rate to Rise to 6% This Year. And Then Stay There.

Fed Funds Investors Predict Big Rate Cuts Because:

- Recession Risks (But Fed Says Inflation Trumps)
- They Expect Sharp Slowdown in Inflation in 2023 (Powell & Co 'Don't See It Happening. We Just Don't')
- Bank Crisis (But Has Nothing to Do with Funds Rate)

23Q1 Real GDP Up +3%, Consumption +4½%, Deceleration Thereafter – +1½% Trend thru 2025.

Fed Funds Target Rate Outlooks

Now: 4¾-5%	Spring 2023	2023-H2	2024-25
Jay Powell	+25-50BP Hikes	No Rate Cuts	-175BP Rate Cuts
Fed Funds Future	+25BP Hikes	-50BP Rate Cuts	-175BP Rate Cuts
Avalan	+50BP Hikes	Another +50BP Rate Hikes	No Rate Cuts

At the March FOMC meeting, chairman Powell flatly declared that he saw no chance for rate cuts in 2023. He did not comment on the FOMC dot plot that did show cuts in 2024-25. Fed funds futures have priced in those 2024-25 cuts, plus some more cuts this year. In contrast, Avalan believes that stubborn inflation data will leave Powell no choice but to extend his "no cuts" pledge indefinitely.

The Swell Before the Slump

While most were focused on the sagging economy, the first quarter snuck in with pretty good results. Real GDP likely grew +3% in 23Q1; real consumption did even better, likely more than +4½% annualized. (23Q1 Advance GDP report out on April 27). In late 2022, Avalan and the consensus were looking for much softer growth, half that or less.

AVALAN'S Key Takeaway:

The environment continues to favor active allocations over a purely passive approach.

Much of this upside surprise was due to international trade distortions caused by the threatened U.S. rail strike and by COVID shutdowns in China. That roiled already beleaguered supply lines and shifted holiday and other consumer purchases.

The surge in payroll jobs in January was probably just volatility. Regardless, this "extra" growth has been a short-lived interruption. Almost across the board, late quarter data have been in the doldrums.

In short, what Avalan has deemed the Great Deceleration is still on. For the rest of 2023 – and indeed through 2025 – we expect the real growth trend to struggle to maintain +1.5%. This is somewhat below the economy's underlying potential (close to +2%), exactly what the FOMC is looking for to help rein-in considerable inflation pressures. It meets the Fed's goals, but Fed policy is not the cause of the Deceleration. After nearly +500BP in rate hikes over the past year, the funds target is barely positive in real terms.

No, as Avalan has been predicting since the start of the pandemic, this is the inevitable payback from ill-considered "stimulus" policies, both fiscal and monetary. *Disclaimer: Advisory services are offered through Avalan, LLC, a Registered Investment Adviser.*

In part because monetary policy is not yet particularly tight, Avalan believes core inflation will stay stubbornly high. This, in turn, will force the FOMC to be tougher and to maintain that stance. The "terminal" fed funds target rate should reach 6% before the end of this year, i.e., +100BP in further rate hikes. Most likely, +25BP per meeting ahead. Avalan's position is quite different than the consensus view.

Many analysts and, particularly, fed funds futures investors are expecting significant rate cuts in coming months and continuing in 2024. Avalan has been on the mark for this entire cycle, and we think we are (still) correct. Fed chairman Powell does too, for the most part. Powell stated flatly that there will be no rate cuts this year. We agree.

The latest FOMC dot plot does contain just 1-2 more +25BP rate hikes where Avalan sees four hike. But the FOMC has had to increase the amount of tightening in each of the last five dot plots; they will have to do so again. And again. And again. Ditto for rate cuts. The dot plot now has some cuts in 2024 and 2025, but they will be pushed back, again. And again. And again…

'No Cutsies'

We all remember the cardinal rule from grade school: no cutting in line. A rule that is still enforced today, more politely we trust, in supermarket checkouts, movie theaters, et al. No rate cuts, we believe, will also be the rule at the Fed for the next few years.

Most analysts are expecting just one more +25BP rate hike this year (at the May 3rd meeting). Avalan is looking for four more hikes (at the next four meetings). Fed funds futures assume that the FOMC is done with its tightening arc and will soon begin cutting rates in a big way. This projection relies on three assumptions, all of which are quite wrong, Avalan believes.

First, futures assume that heightened recession risks will stay the FOMC's hand. Avalan does not believe that recession is likely. Regardless, Powell and even FOMC doves have insisted that reining-in inflation is the undisputed priority. Second, futures assume that core inflation will wind down quickly. Powell, in the most candid Fed moment in generations, dismissed that last month, declaring "we don't see that [inflation drop-off] happening. We just don't." Neither does Avalan.

Finally, futures think that banking sector woes will push the Fed's anti-inflation campaign not just to the back burner but off the stove entirely. Well, such fears did not stop last month's rate hike; they will not stop the next hike (or several hikes). Avalan contends that rate hikes did not cause the banking sector's problems and rate cuts would not solve them. High inflation and the resulting quest for higher yields sparked the bank runs. If the Fed had kept short rates ultra-low, inflation fears and long rates would have risen accordingly. If other banking "shoes" do drop, the Fed will respond as lender of last resort. They can do that and fight inflation at the same time.

What's Ahead?

Core inflation has been stubborn and the Fed's battle against inflationary pressures has introduced substantial uncertainty into financial markets. Additionally, employment and corporate earnings are not yet fully reflected in earnings expectations. This, and the situation surrounding community and regional banks has resulted in growing concerns about a potential recession in the next 12-18 months. Avalan expects domestic equities to experience continued higher volatility along with return headwinds from multiple compression. Our portfolios therefore place a greater focus on quality of fundamentals rather than pure revenue growth. The environment continues to favor active allocations over a purely passive approach.