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ON THE RADAR

FAQs on the Markets and Economy

Is the Fed changing its strategy?

On May 3, the Fed increased the federal funds rate by 25 basis points (bps), which raised the median level to 5.125%, the highest level in 16 years.

The fund's rate now stands five percentage points above the level a little over a year ago, making it the most rapid series of increases since the 1980s when Paul Volker was head of the Fed (see chart).

The Fed is signaling it might be done with interest rate increases for now. This is a change for it. In the past, it saw many signs of the economy's strength to justify raising interest rates. It believes it is at the correct level and will only raise interest rates further if it sees signs of stronger-than-expected inflation, personal spending, and hiring. As a result, the Fed appears to be taking a "pause."

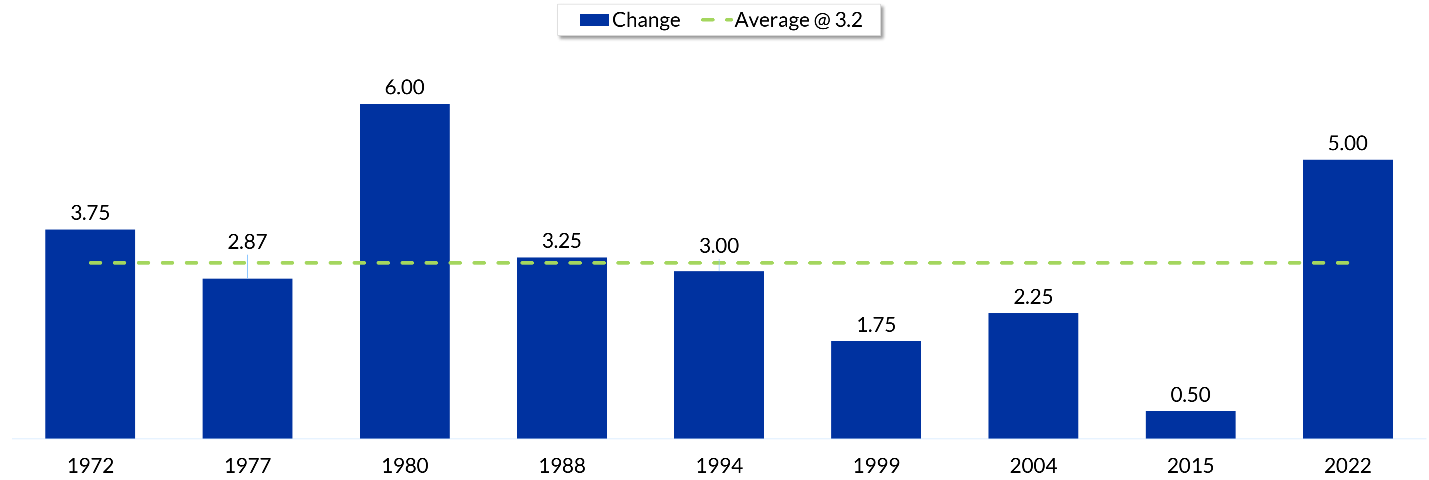
Although short-term interest rates may stay stable, there are still increasing restrictions on economic growth due to the Fed continuing to allow bonds to mature out of its portfolio (quantitative tightening) and the banking sector continuing to raise credit standards.

KEY QUESTIONS

- Have long-term rates peaked?
- What's the latest on the debt ceiling?
- How resilient is the labor market?

Federal Funds Rate

change in rate 14 months after initial hike, in percentage points



Source: Federal Reserve Bank, May 3, 2023

Please note: Information is subject to change and is not a guarantee of future results.

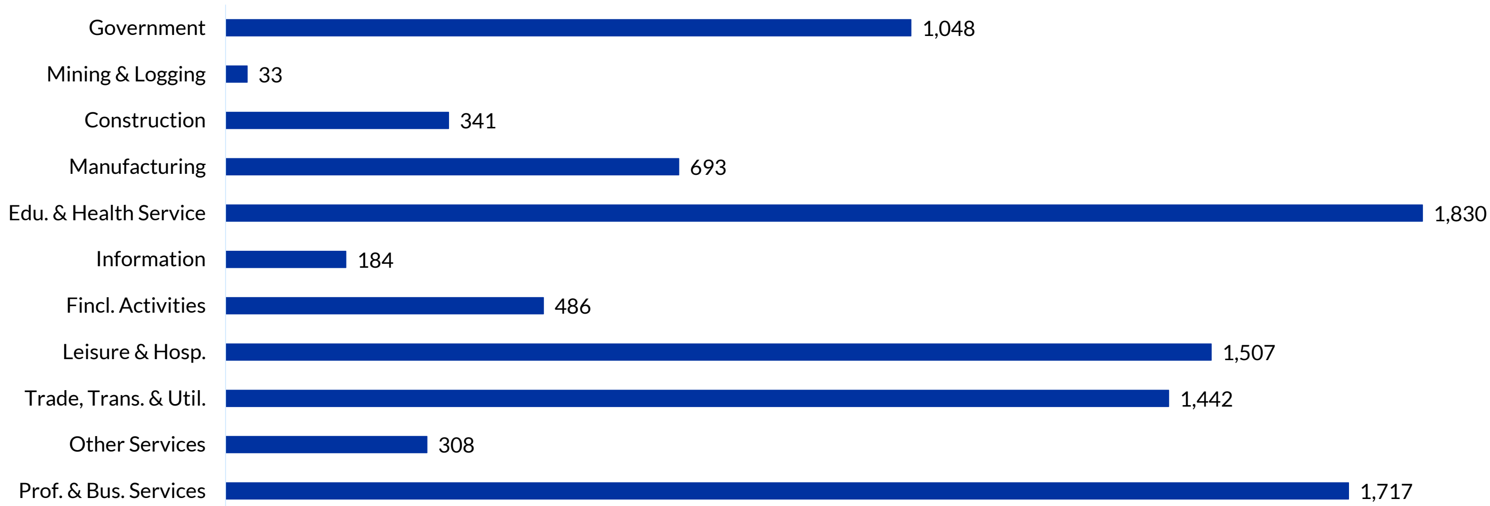
How resilient is the labor market?

It has been remarkably resilient.

Since last year, market expectations for gains in payroll growth have consistently been lower than actual reports. For example, the most recent data from April's labor report showed payroll gains increasing by 253,000, slightly stronger than March's gain of 236,000, but well above the market expectations of 185,000. By historical standards, that is a significant difference between expectations and reality. What makes that more impressive is it happened despite the turmoil in the banking sector and signs of an economic slowdown.

Although there have been many news articles about layoffs, especially in the tech and entertainment sectors of the economy, there is still demand for many workers in all sorts of professions (see chart). Currently, there are 9.6 million job openings. Although that number is down from the peak of 12.0 million last March, it is well above the pre-pandemic level of 7.2 million and the long-term average of 5.1 million job openings.

Job Openings: March 2023
'000, seasonally adjusted



Source: Bureau of Labor Statistics, March 2023

Please note: Information is subject to change and is not a guarantee of future results.

What's the latest on the debt ceiling?

April's disappointingly low tax receipts mean that the deadline to raise or suspend the debt ceiling is now likely to come sooner than most had previously thought.

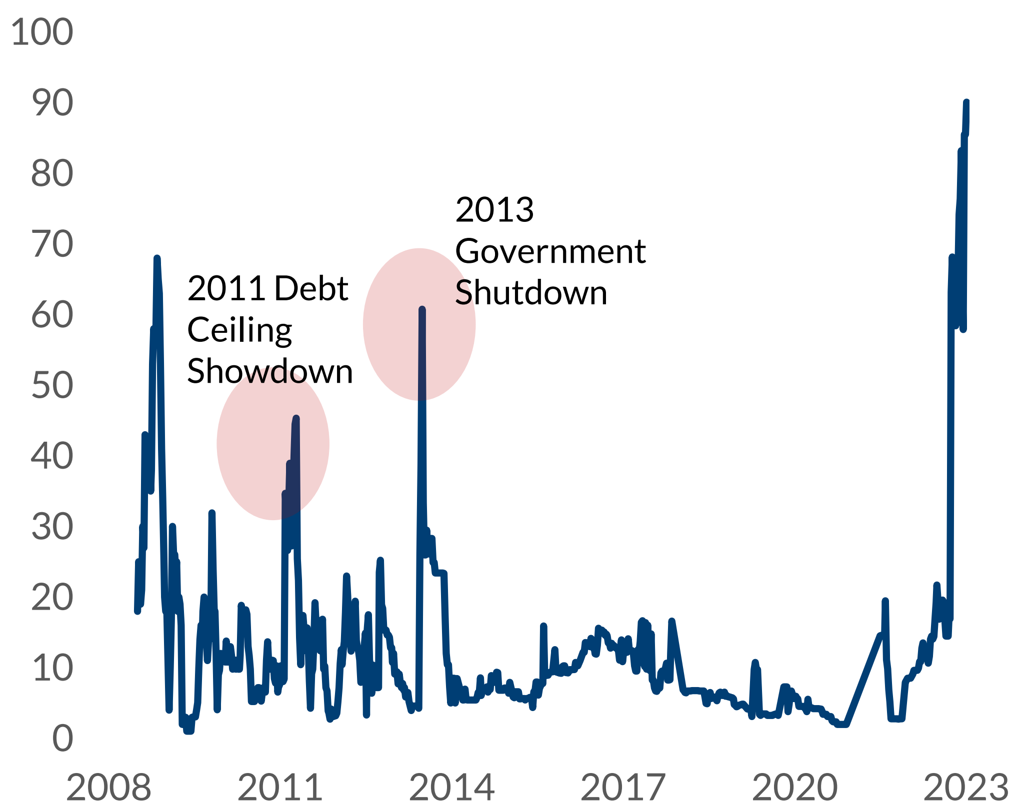
Unfortunately, the stalemate in Washington continues, and with both sides of the political aisle deeply dug in, a near-term breakthrough appears unlikely despite meetings scheduled this week between the White House and congressional leadership.

Ultimately a last-minute bipartisan deal to raise the debt ceiling alongside modest cuts to government spending still appears to be the most likely way out of the current impasse but uncertainty over the exact timing of the deadline suggests a chance of a misstep.

Investors are beginning to take notice. The bond market appears to be assuming a much higher probability of a default— or at least a temporary delay to debt repayment— this time around. The cost of insuring against default for U.S. government debt has surged far above the peaks seen in 2011, 2013 or during the financial crisis.

Those concerns are only likely to grow over the coming weeks, but it may take more serious signs of stress, potentially involving significant volatility in the stock market, to finally push lawmakers into action.

U.S. One-Year Sovereign CDS Spreads



Sources: FactSet, CNR Research, as of March 2023

Please note: Information is subject to change and is not a guarantee of future results.

Have long-term rates peaked?

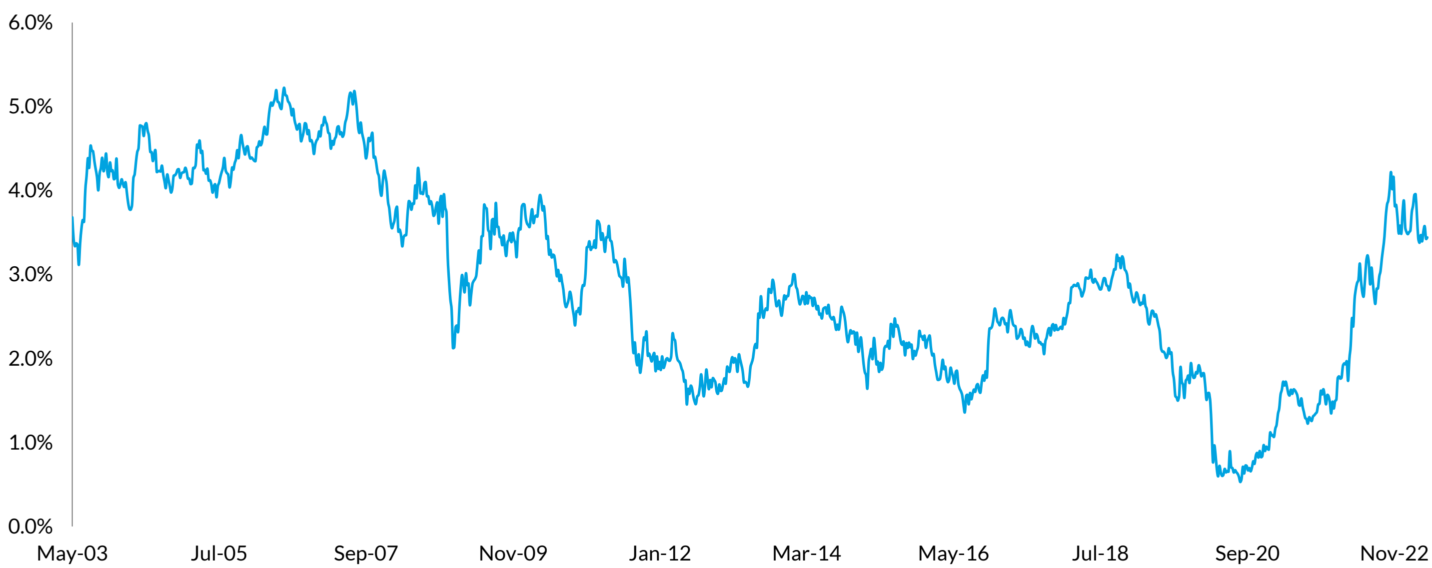
It has only been 14 months since the Federal Reserve target rate was zero.

At the time, the potential for Federal Reserve hikes seemed slim on the heels of the pandemic, but as the level of inflation climbed, reaching a peaking over the summer of 2022, rate hikes became the norm. Long-term interest rates followed, climbing to a 15-year high of 4.3% on October 21, 2022. But now, expectations for slowing growth, lower inflation and various exogenous risks coming from the financial sector and Washington and ongoing conflict in Europe have set the stage for economists to project lower long-term interest rates. This is in stark contrast to a Federal Reserve that believes rate cuts are unlikely in 2023, notably different from the market's anticipation of at least three cuts by the end of the year.

So is the constricting pressure of 4%+ interest rates behind us, or is the market simply wrong? There are good reasons to believe that rates may have peaked, especially considering the historical comparisons to other tightening cycles. But in this environment, the historical data may not be much help. The impact of COVID-19 cannot be understated, nor can the excessive government spending that flooded the economy in the wake of the virus. Combined with the political standoff on the debt ceiling, we are far from all-clear.

Given the complete disagreement between the market and the Federal Reserve, long-term rates appear poised to rise. The flight-to-quality sparked by the financial sector, expectations for lower rates and optimistic forecasts for inflation are only temporarily factors bringing rates down. All are at risk of reversing, and, if these market expectations unwind, higher rates will come. We continue to believe that the 10-year Treasury yield has the potential to challenge the highs set last year.

10-Year U.S. Treasury Yields



Source: Bloomberg, as of May 5, 2023

Please note: Information is subject to change and is not a guarantee of future results.

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