US Watch

March FOMC: Tighter lending standards mean less policy rate firming

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Key takeaways

- As expected, the Fed lifted the target range for the federal funds rate by 25bp at its March meeting to 4.75-5.0%
- Most participants see appropriate policy as calling for a lower terminal rate than Fed communications were guiding previously
- We no longer expect a 25bp rate hike in June and now foresee a terminal target funds rate of 5.0-5.25% reached in May

Excess tightening in bank lending standards to substitute for policy rate firming

The outcome of the March FOMC meeting was broadly as we expected. The Fed lifted its policy rate by 25bp. That said, the Fed has taken on board some amount of tightening in credit standards and terms as a result of the recent stresses that emerged from several regional banks. As reflected in the statement, most participants saw appropriate policy as calling for a lower terminal rate than Fed communications were guiding markets to just a few weeks ago.

The US economy may see tighter lending standards than what could be explained by macroeconomic fundamentals. Following today's developments, we no longer expect a 25bp rate hike in June and now foresee a terminal target funds rate of 5.0-5.25% reached in May. Should the stresses in the financial system be reduced in short order, we cannot rule out that stronger macro data will lead the Fed to put in additional rate hikes beyond May, but for now we think risks are in the direction of an earlier end to the tightening cycle.

Market reaction

The rates market saw today's FOMC action as a dovish hike. This dovish interpretation was seen through 2Y & 10Y rates lower on after FOMC communications by 14 & 3bps respectively, resulting in bull steepening on the UST curve. This re-affirms our view for lower rates over time. The shift in Fed rhetoric and possibility of credit tightening substitute for rate hikes also likely means that the UST curve is biased to move steeper vs flatter.

In FX, the FOMC statement and press conference was broadly USD-negative on net, with the dollar mainly following front-end US rates. Depreciation was broad-based, with most G10 and EM currencies between 0.5 and 1.0 % higher on net since 2PM ET, amid notable intraday volatility. Overall, we still see currencies ultimately being rewarded for central banks maintaining inflation fighting resolve.

Refer to important disclosures on page 4 to 5.
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US Economics: We lower our expected terminal rate to 5.0-5.25%

The outcome of the March FOMC meeting was broadly as we expected. The Fed lifted its policy rate by 25bp. That said, the Fed has taken on board some amount of tightening in credit standards and terms as a result of the recent stresses that emerged from several regional banks. While Chair Powell said the true extent of this tightening is unknown, and dependent on how well Fed actions to date reduce spillover risks, he said most committee members factored this effect into their forecasts. Hence, most participants see appropriate policy as calling for a lower terminal rate than Fed communications were guiding markets to just a few weeks ago. This was reflected in the statement by saying "some additional policy rate firming may be appropriate" versus prior language that said “ongoing” rate hikes may be needed.

We agree that some amount of unexpected tightening in bank lending standards may be forthcoming. In other words, the US economy may see tighter lending standards than what could be explained by macroeconomic fundamentals. If so, our view is that it could indeed substitute for further rate hikes (see the report Estimating downside risk from a sharp tightening in bank lending standards, 21 March 2023). Hence, we no longer expect a 25bp rate hike in June and now foresee a terminal target funds rate of 5.0-5.25% reached in May.

Should the stresses in the financial system be reduced in short order, we cannot rule out that stronger macro data will lead the Fed to put in additional rate hikes beyond May, but for now we think risks are in the direction of an earlier end to the tightening cycle.

US rates: March FOMC- dovish hike

The rates market saw today’s FOMC action as a dovish hike. This dovish interpretation was seen through 2Y & 10Y rates lower on after FOMC communications by 14 & 3bps respectively, resulting in bull steepening on the UST curve. The rates market interpretation was driven by: language in statement and press conference discussing tighter credit conditions, “some” vs “ongoing” policy firming, and Powell’s comments that the Fed considered a pause. Powell also made clear that the expected tightening in credit standards would effectively substitute for rate hikes.

The dovish hike re-affirms our view for lower rates over time. The shift in Fed rhetoric and possibility of credit tightening substitute for rate hikes also likely means that the UST curve is biased to move steeper vs flatter. A Fed more cautious about credit standard tightening is likely to mean a more moderate pace of rate hikes, if any additional rate hikes at all. This would mean that the market is likely to see soft economic data as implying a lower bar for rate cuts, while strong data may be met with higher inflation risk premium and wider breakevens further out the curve. Consistent with this latter market interpretation, 10Y breakeven rates of inflation widened meaningfully following today’s FOMC communications.

On monetary policy implementation, the setting of Fed administered rates in the target range was unchanged. We expected this outcome and have consistently pushed back on the notion of an imminent widening of the IORB (interest rate on reserve balances) to ON RRP (overnight reverse repurchase) spread. If the Fed wanted to set monetary policy in a way to limit bank deposit outflows, a more effective way would be to abstain from raising rates. If the Fed wants to ensure that money market rates remain within the target range, then they need to keep the setting of administered rates at current levels within the range.

FX: USD-negative on net

In FX, the FOMC statement and press conference was broadly USD-negative on net, with the dollar mainly following front-end US rates. Depreciation was broad-based, with most G10 and EM currencies between 0.5 and 1.0 % higher on net since 2PM ET, amid notable intraday volatility. The dollar’s depreciation occurred both on the statement release and throughout the press conference, consistent with the broad interpretation of a “dovish hike”. In particular, the change in the statement guidance from “ongoing increases…will be appropriate” to “some additional policy firming may be appropriate”, appeared to be the main initial catalyst. The dollar’s depreciation extended into the press conference, accelerating as Powell noted that a pause was considered by the committee, though the moves appeared to consolidate slightly on his statement that “if we need to raise rates higher than expected we will”.

Overall we still see currencies ultimately being rewarded for central banks maintaining inflation fighting resolve. The extent to which this financial turmoil upends this will be critical, though it appears too early to tell the extent to which credit tightening conditions will have on inflation. On a relative basis, we continue to watch how other central banks evolve, and see the dollar’s outlook in this context as well. Tomorrow’s BOE (we expect at 25bp hike), Norges Bank (we expect a 25bp hike) and SNB (we expect a 50bp hike) meetings will be the next watch points for the FX market.

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