The Fed Will Still Raise Rates in March, And That's Why Rates May Keep Falling

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There's certainly a chicken/egg problem when it comes to interest rate news. Is it the Fed's decisions that move rates? Or do market forces move rates, thus forcing the Fed to react?

The answer is somewhere in between. If inflation and economic growth were always positive, low, and stable, the Fed would never lift a finger, but they are compelled to act when stability is threatened.

Since March 2020, the Fed has acted quite a bit. They maintained rate-friendly policies for almost 2 years and then got precipitously unfriendly early in 2022. "Unfriendly," in this case, refers to hiking the Fed Funds Rate and buying fewer bonds on the open market. The combined effect was one of the sharpest rate spikes in history.

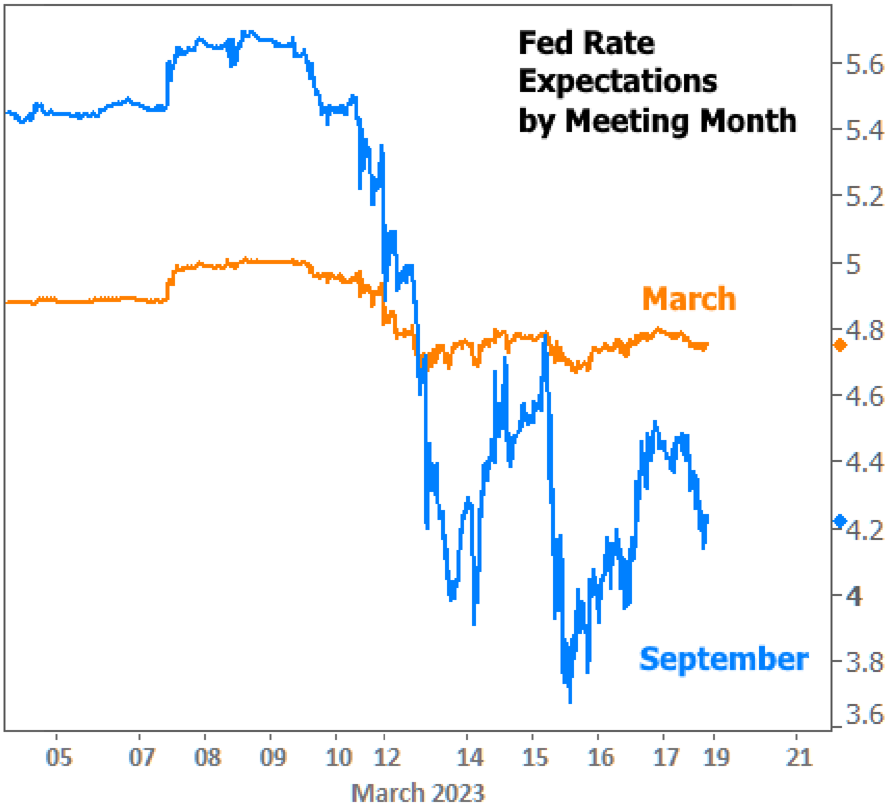
Now after more than a year of unfriendliness, the Fed is finally thinking about leveling off and seeing how things play out without too many more rate hikes. They've already decreased the pace from 0.75% per meeting to 0.25%.

This isn't a random decision on the part of the Fed. It comes in response to shifts in inflation data as well as other signs that their unfriendly policies are having an effect on the economy.

The latest sign is the banking drama that has been in the news this week. It began with Silicon Valley Bank last week but spiraled into a bigger problem with the closure of Signature bank over the weekend. Many people have never heard of these institutions, but they now represent the 2nd and 3rd largest bank failure in US history.

Many people have heard of Credit Suisse. While the European institution has been on shaky ground for months, markets nonetheless reacted to news that it too could get swept up in the recent drama. The stock price plummeted almost all week and other European banks moved lower in sympathy.

All of the above contributed to yet another week with an obvious "flight to safety" in the market. In not so many words, this involves selling riskier assets like stocks and buying bonds. When traders buy bonds, it pushes interest rates lower (represented by US 10yr Treasury yields in the chart below), all other things being equal.

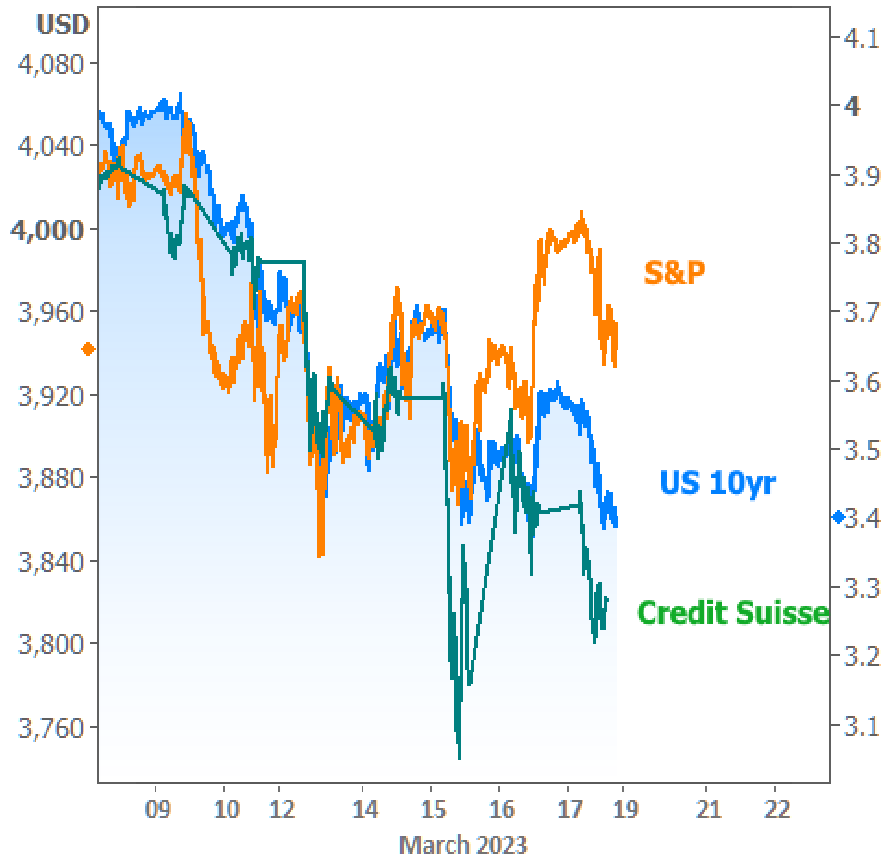


Despite the apparent panic in financial markets, the Fed will almost certainly continue to hike rates when it meets next week. It will also almost certainly signal that additional rate hikes are possible, if not probable, and that they depend much more on the path of inflation than on a handful of mismanaged banks experiencing trouble coping with a tough rate environment.

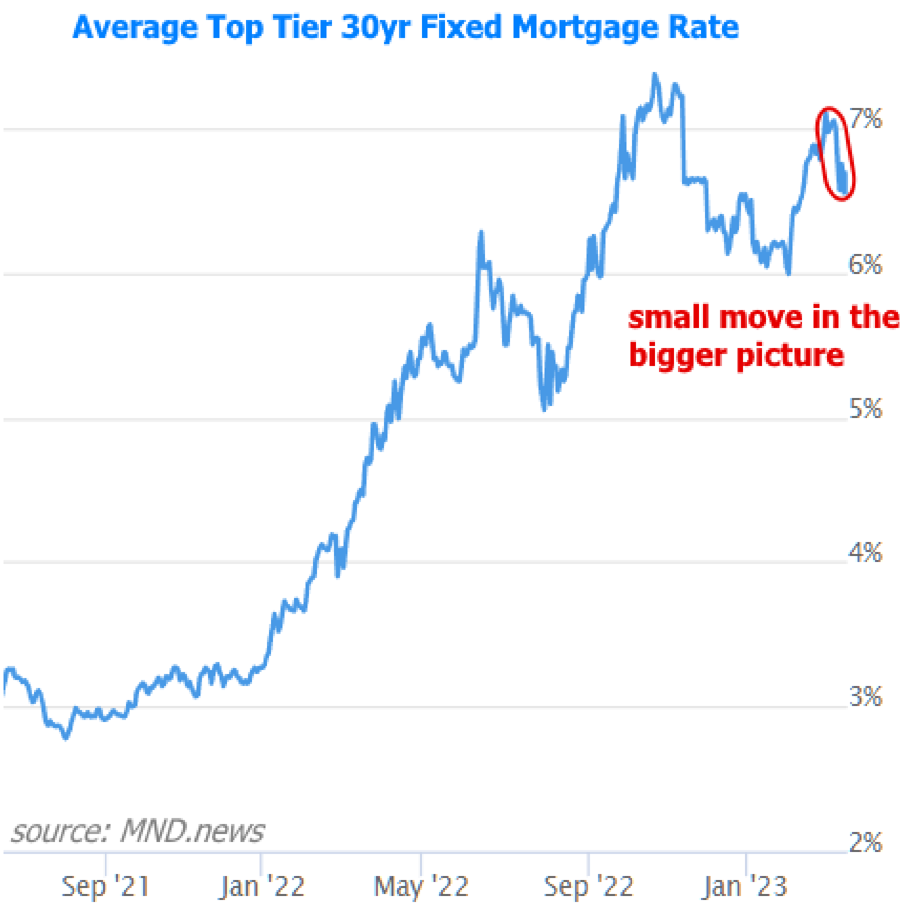
When that happens, keep in mind that the market is less concerned with how the Fed changes rates at the current meeting and more interested in how the rate outlook evolves for the coming months. That outlook is driven by two things: the Fed's stance on the economy and the economy itself.

By maintaining a tough stance on rates, the Fed makes it harder for the economy to experience strong growth. It also means inflation will have a harder time experiencing a resurgence. That adds up to downward pressure on rates in the longer term.

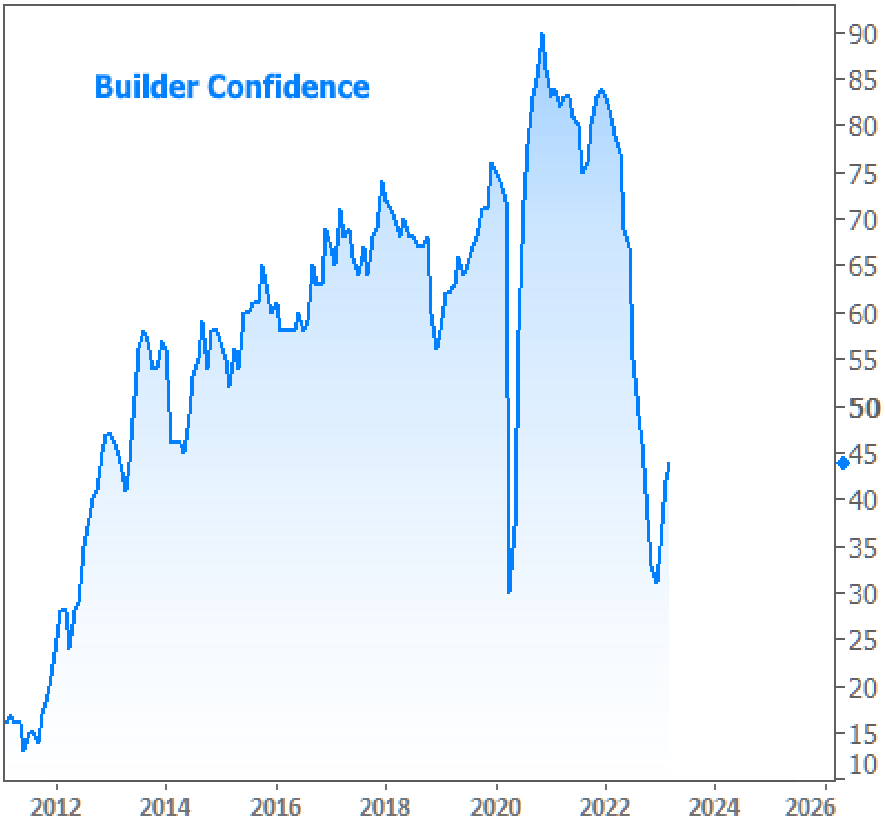
As for the current week, the drop in rates was driven not only by the flight to safety, but also the expectation that the Fed will be able to start cutting rates by the end of the year. This can be seen in the following chart with September's Fed Funds Rate expectations falling below March.



Unfortunately for the mortgage market, a classic flight to safety tends to benefit Treasuries first and foremost, even though the 10yr Treasury is often used as a benchmark for mortgage rate movement. Mortgages definitely improved--just not as noticeably as Treasuries.



That's OK though. The most sustainable improvement in mortgage rates is the improvement that happens gradually. The housing market is already responding the the apparent ceiling in rates seen in the chart above. Ever since the highs in late 2022, housing metrics have slowly come off their lower levels, as seen in the latest construction and builder confidence data released this week.



Existing and New home sales will both be released next week for the month of February, but when it comes to market movement and the impact on rates, all eyes will be on Wednesday afternoon's Fed events.

Why events? It's not just the Fed's rate hike that happens on Wednesday. They'll also have quite a few updates to the verbiage of the policy announcement. Those words will help frame the policy path going forward. Markets will get even more clarity and insight from the updated forecasts for future rate hikes (or cuts?) submitted by each Fed member. Those forecasts will likely be at odds with market expectations and it will be interesting to see how the market reacts when confronted with that reality.

Last but not least, every Fed day concludes with a press conference from the Fed Chair. This one will be one of the most important and informative in recent memory as Powell will be forced to choose between policy goals and calming a potentially panicked market.