US Daily: March FOMC Recap: Tighter Credit Can Substitute for Rate Hikes (Mericle)

- The FOMC raised the funds rate by 25bp today to 4.75-5%, against our expectation of a pause, but projected a weak economic outlook for the rest of 2023 and a more cautious path for the funds rate than Chair Powell had indicated was likely before the recent banking turmoil. Powell said that tighter credit conditions are likely to weigh on economic activity and might substitute for one or more rate hikes, but he was quick to note that the FOMC could reevaluate as it learned more about the impact of recent events.
- We also expect stress on small and midsize banks to result in a tightening of lending standards, which we estimate will impose a ¼-½pp drag on GDP growth, equivalent to the impact of 25-50bp of rate hikes. While we also think that the pressure on banks has raised the odds of a more serious downside scenario, our baseline economic forecast is stronger than the FOMC's.
- We have left our forecast for the peak funds rate unchanged at 5.25-5.5% and now expect additional 25bp rate hikes in May and June. Our baseline forecast is 25bp above the FOMC's forecast of 5-5.25%, and our weighted-average path for the funds rate is above market pricing.

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March FOMC Recap: Tighter Credit Can Substitute for Rate Hikes

The key question for the March FOMC meeting today was how concerns about stress on small and midsize banks would affect the Committee's rate hike decision and economic and monetary policy projections.

Chair Powell emphasized that the banking system is sound and resilient, and that the Fed has taken powerful actions alongside the Treasury and the FDIC. He said at the start of his remarks that "depositor savings are safe" and later reaffirmed that "all depositors savings and the banking system are safe."

Both the FOMC statement and Powell noted that recent developments are likely to result in tighter credit conditions, which will likely weigh on economic activity. In fact, the FOMC's forecast implies that the economy will be quite weak in the rest of the year. The median projection showed just 0.4% GDP growth in 2023, which would imply -0.4% annualized growth in Q2-Q4 if Q1 lands between our tracking estimate and the Atlanta Fed's, as well as a 0.9pp increase in the unemployment rate, even though—as the FOMC statement noted—job gains have been "running at a robust pace" recently.

Despite this weak economic outlook, the FOMC hiked by 25bp today, against our expectation of a pause. The likely impact of tighter credit conditions, which Powell said could be "the equivalent of a rate hike or perhaps more than that," was instead apparent in the median projection of the future path of the funds rate. The median dot showed a 2023 funds rate of 5-5.25% that was unchanged from December, instead of the increase that Powell had previously said that he anticipated before the banking turmoil.

Powell was quick to note that the FOMC had "absolutely not" tied its hands with its forecast of just one more 25bp hike and could reevaluate as it learned more about the impact of recent events.

Like the FOMC, we also expect stress on small and midsize banks to result in a tightening of lending standards. We estimate that this will impose a ¼-½pp drag on GDP growth, equivalent to the impact of 25-50bp of tightening in our financial conditions index or 25-50bp of funds rate hikes.

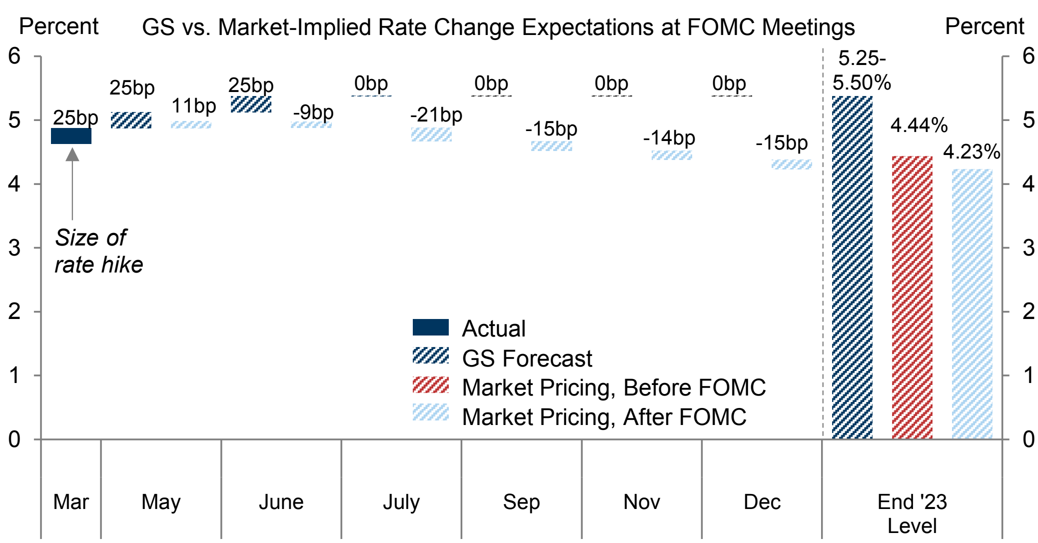
Even after incorporating this drag, our baseline forecast for the economy this year is stronger than the FOMC's. We expect GDP growth of 1.2% in 2023 on a Q4/Q4 basis instead of the FOMC's 0.4%, and we expect the unemployment rate to remain unchanged at 3.6% instead of rising to 4.5%.

We do think that the pressure on banks has raised the odds of a more serious downside scenario, but a moderate rather than a severe drag on growth is our base case for several reasons. First, it is not clear that large banks will tighten lending standards. Second, lending standards had already tightened sharply in prior quarters due to widespread recession fears. Third, the multiplier effect should be low in an economy with excess demand for workers. And fourth, in the area of lending where small and midsize banks play the most outsized role, commercial real estate, demand for loans is likely to be weak anyway.

We have left our forecast for the peak funds rate this year unchanged at 5.25-5.5%, 25bp above the FOMC's forecast of 5-5.25%, and now expect additional 25bp rate hikes in May and June.

Market expectations for the path of the funds rate through the remainder of the year declined sharply today, as shown in Exhibit 1, most likely because the FOMC's funds rate projections were lower than expected. We are surprised by the size of the move because we do not think that we learned very much about the FOMC's reaction function today.

Exhibit 1: Market Expectations for the Funds Rate at the End of 2023 Declined by 21bp Today

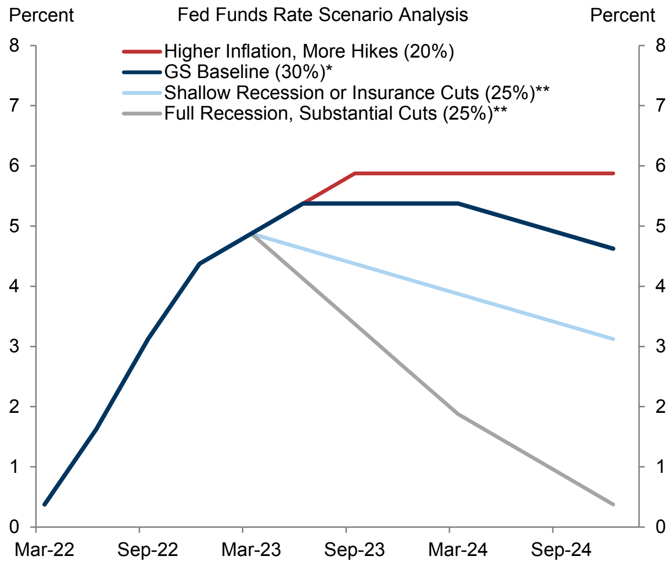


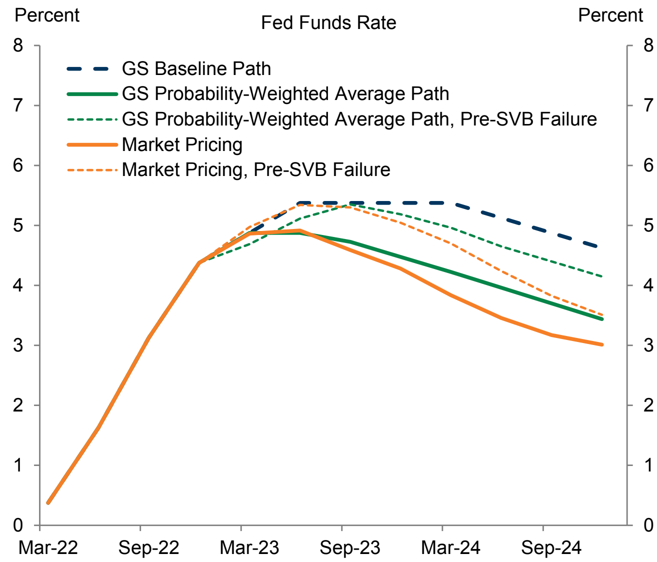
Source: Goldman Sachs Global Investment Research

We can still imagine a wide range of possible paths for the funds rate. We think that recent events have made future 50bp hikes much less likely and reduced the odds of the funds rate rising above 6%. One other change to our thinking is that we are increasingly open to the possibility that a persistently deeply inverted yield curve could add to strain on banks' financial health enough to be at least one contributing rationale for lowering the funds rate in the future. We had previously only expected the FOMC to cut when a growth scare emerges, but we could now envision a combination of a substantial decline in inflation and a desire to relieve the pressure on banks potentially adding up to a reason to lower the funds rate.

Exhibit 2 shows an update of our funds rate scenario analysis. We have increased the probability of our baseline scenario by 5pp and lowered the probability of our upside scenario by 5pp. Our weighted-average path for the funds rate has fallen sharply since the recent problems emerged in the banking sector (the dotted green line on the right-hand side has fallen to the solid green line), but it remains above market pricing (the solid green line is above the orange line).

Exhibit 2: Our Probability-Weighted Fed Forecast Is Somewhat Higher Than Market Pricing





* The cuts in our baseline scenario are meant as a placeholder for an uncertain future date when a material risk to growth emerges.
** The recession scenarios show unrealistically slow cuts to capture many sub-scenarios of recessions starting at various points in time. The recession scenarios reflect our subjective recession probability of 35% over the next 12 months and continued elevated risks thereafter

Source: Goldman Sachs Global Investment Research

David Mericle

Disclosure Appendix

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We, Jan Hatzius, Alec Phillips, David Mericle, Spencer Hill, CFA, Joseph Briggs, Ronnie Walker, Tim Krupa and Manuel Abecasis, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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