The Federal Reserve's Monetary Policy Plans

Potential Implications for the Fixed Income Market

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As widely anticipated by markets, the Federal Open Market Committee (FOMC) raised its key short-term interest rate, the federal funds rate, by a quarter-percentage point (0.25%) at its March meeting. In addition, a survey of Federal Reserve (Fed) officials indicated the potential for six additional rate hikes this year and four hikes in 2023.

In an effort to gain greater insight into the Fed's monetary plans for the remainder of 2022 and the potential implications for the short-term fixed income market, we conducted the following Q&A session with Jeffrey Rowe, CFA, managing director and senior portfolio manager within PFM Asset Management's investment advisory team.

Jeff, what is the role of the Federal Reserve? How does the Fed use monetary policy to achieve its objectives?

Rowe: The Federal Reserve serves as the U.S. central bank. Under the Federal Reserve Act, the origin of which dates all the way back to 1913, the Fed's mission is to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." The first two of these objectives are referred to as the Fed's dual mandate. To achieve these goals, the Fed utilizes monetary policy tools to either slow down or stimulate the economy.

The Fed also has important roles in supervising and regulating the U.S. banking system; ensuring the stability of the financial system; providing financial services to the U.S. government, U.S. financial institutions, and foreign central banks; and operating the nation's payments systems.

You mentioned the dual mandate. Where are we today in terms of employment and prices?

Rowe: In terms of reaching maximum employment, the U.S. labor market has quickly recovered following the sharp downturn at the emergence of the global pandemic in 2020. Recently, the headline unemployment rate fell to a post-pandemic low of 3.8% with strong monthly jobs gains. The U.S. economy added over one million new jobs in just the first two months of the year. With a robust labor market, the Fed's focus is now squarely on the inflation side of the mandate.

A variety of inflation indicators have continued to move higher in recent months. Consumer prices have risen at the fastest pace in four decades, with the Consumer Price Index (CPI) at 7.9% in February 2022. After insisting that inflation was transitory for much of 2021, the Fed has now acknowledged that broad-based inflation has taken hold and is likely to take longer to return to its 2% long-term target than previously expected.

How many times will the Fed raise rates this year?

Rowe: Since the Fed is always data-dependent, we don't know for sure. But, at the March FOMC meeting, the Fed's median projection for the appropriate federal funds rate level signaled an expectation for seven interest rate hikes in 2022, which would push the overnight rate to nearly 2% by year-end. This is a full percentage point higher than the prior published projections from December 2021 and is a good example of how quickly monetary policy expectations can change. Looking out further, our central bank believes rates may top out at almost 3% by the end of 2023. While this represents current Fed and market forecasts, it is important to recognize that monetary policy will continue to adapt based on incoming data in the coming quarters. But clearly, the Fed is in rate hike mode and playing catch-up on the inflation front.

Could the conflict in Ukraine alter the Fed's view or policy moves?

Rowe: Russia's invasion of Ukraine is first and foremost a humanitarian crisis and is causing tremendous economic hardships. The geopolitical situation in Eastern Europe is also a source of great uncertainty for the global economy. In a typical situation where inflation is not running rampant, Treasury yields would usually fall in a 'flight to quality' and central banks would offer support to jittery global markets. However, the Fed is keenly focused on the price-stability goal and is intent on normalizing interest rates to slow inflation. Making matters worse, the conflict in Ukraine is inflationary. Disrupted global supply chains, massive trade sanctions and unstable markets have sent commodity prices soaring. This backdrop will likely cause the inflationary trend to worsen in the near term, particularly for food and energy prices. In the U.S., according to AAA, we are seeing the highest gasoline prices on record, with a gallon of regular gas costing an average of $4.27 (as of March 18, 2022).

What are key considerations for public funds investors in a rising interest rate environment?

Rowe: We strongly believe that public funds investors should maintain a disciplined approach to investing throughout economic cycles. This process starts by segmenting cash into multiple investment buckets typically based on when funds are needed – cash or short-term funds to meet near-term liquidity needs and longer-term core investment balances for funds without immediate liquidity needs. Having investments come due when funds are needed reduces the impact of normal market gyrations, including rising rates. To work best over long horizons, this strategy development process can be conducted while being agnostic to current market conditions. This sets the foundation for establishing an appropriate and disciplined overall investment strategy that can also incorporate any unique policy requirements or specific risk tolerances.

When interest rates rise, as they have been in recent months, it may be tempting to abandon longer-duration strategies and wait for higher rates. This is not a strategy that we believe can be successful through market and interest rate cycles, and we encourage our investors to resist the lure of timing the market in their approach to investing public funds. Today, we see excellent investment opportunities in both short-term and longer-term investments.

To learn more or discuss in greater detail, please contact us:

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