APPLAUSE FOR A PAUSE: HAVE WE REACHED THE FED'S FINAL ACT?

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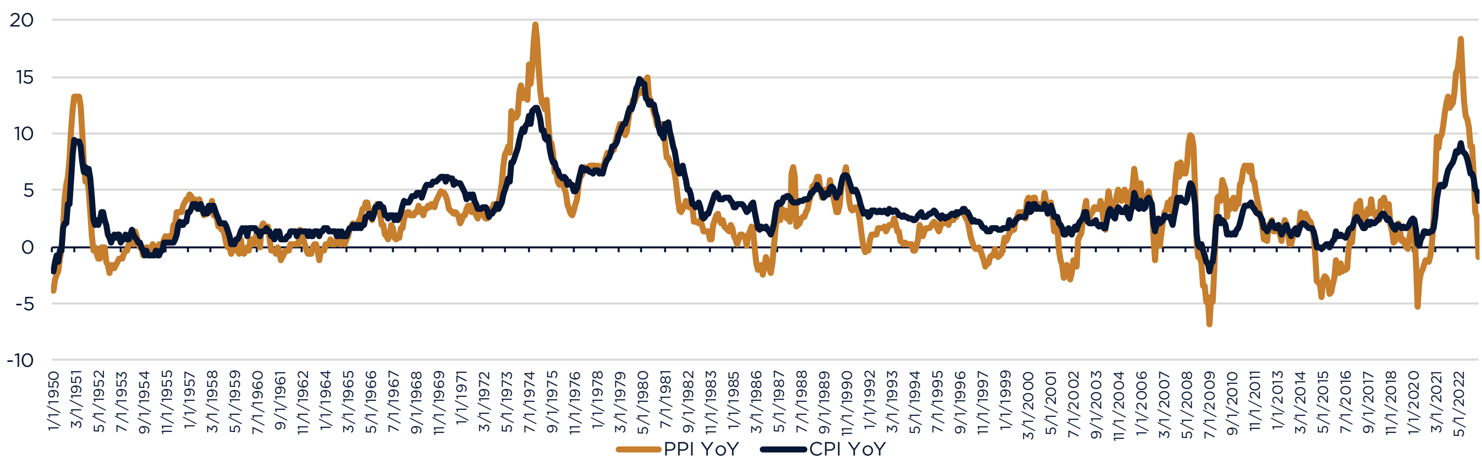
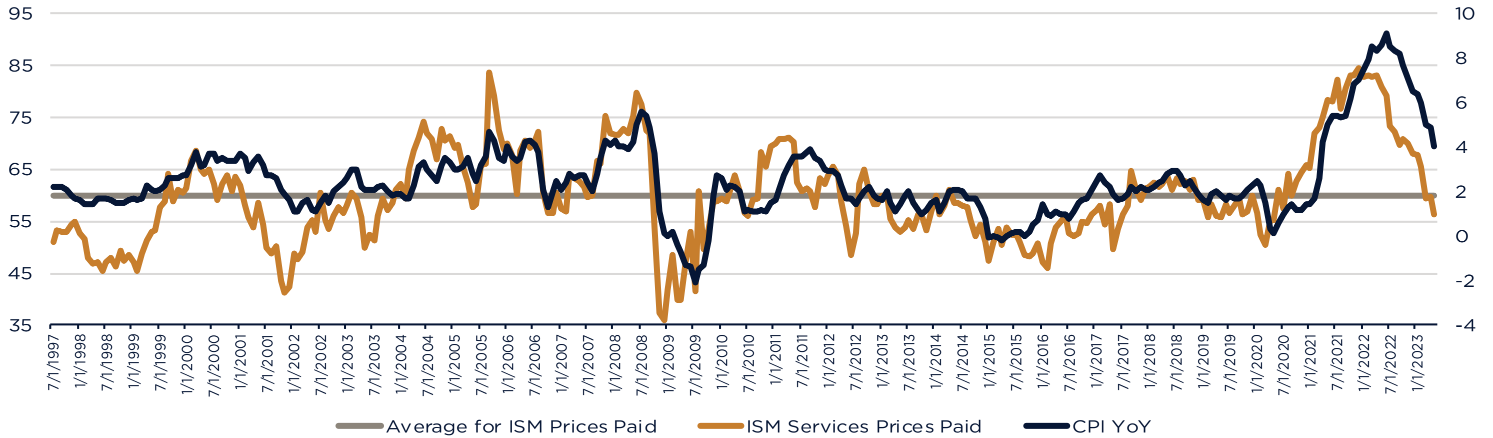
After a grueling 15-month tightening cycle that caught many investors off guard due to its severity and magnitude, the Fed decided to pause hiking at their June meeting. Despite the pause, many called it a "hawkish skip" as the Fed Dot plot indicated the median member expected an additional 2 hikes in 2023, with some FOMC members' forecasts pushing over 6%. Going forward, interest rate valuation is more likely to be driven by the timing and magnitude of rate cuts, rather than the agonizing debate over a final hike or two.

While predicting the path of interest rates is admittedly difficult, our conviction is growing that we are in the final stretch of the Fed's tightening campaign. Inflation has moderated substantially and shows signs of further slowing, though it is still elevated compared to the Fed's inflation target. As a result, the hurdle to continue raising rates from this level will be high. As the charts below highlight, both the Producer Price Index (PPI) and ISM Services Prices Paid have a strong correlation with year-over-year CPI (78% and 56%, respectively). After coming off large COVID reopening peaks in 2021 and 2022, both have slowed considerably. That's reassuring news for the Fed's fight against inflation as both data series have historically led inflation. In concert with other moderating economic data, the disinflation story has a growing number of supporting tailwinds.

For bond investors, the outlook for interest rates remains encouraging. Growing evidence that the Fed is likely at, or near, the end of its tightening campaign means that additional rate hikes should have little impact on longer-term rates. As the market and investors look past the short-term and focus on the timing and magnitude of potential rate cuts, we see somewhat limited upside for rates. However, in the event the economy continues to moderate, eventual rate cuts could provide meaningful downside for rates.





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