WHERE WE STAND

MAY FED MEETING AND RATE ENVIRONMENT

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As expected, on May 4 the Federal Reserve raised the target range of the federal funds rate by 0.50% to 0.75%–1.00% in its largest single-meeting rate hike in more than 20 years. As further rate hikes await the economy and the markets in the months ahead, we believe the following points are important for investors:

- **Along with the rate hike, the Fed also provided official guidance on expected balance sheet reduction.** Amid heavy anticipation as to how much and how fast it would be reducing its $9 trillion of Treasury bonds and mortgage-backed securities, the Fed announced plans for this activity at a pace of $48 billion per month beginning in June and working up to $95 billion by August ($1.1 trillion annually). While this was in line with previous guidance from Fed officials, the official announcement highlighted the direct impact of Fed policy on longer-term bond yields.
- **Following the Fed's official statement, Federal Reserve Chair Jay Powell's guidance appeared to leave the markets somewhat confused.** Prior to the meeting, market expectations, as determined by federal funds futures trading, implied a 0.75% increase to the federal funds target range at the upcoming June meeting. However, during the post-meeting press conference, Chair Powell stated, "A 75 basis point increase is not something that the committee is actively considering." Markets then immediately rallied strong to close the day, only to give it all up and then some in the following day's fierce sell-off as federal funds trading reversed back to expectations of a 0.75% rate hike in June.
- **As recession fears mount, the Fed is walking a tightrope between inflation and slowing economic growth.** Following the Bureau of Economic Analysis' advance estimate of negative 1Q GDP growth, the Fed must now navigate a path seeking to mitigate inflation and avoid recession. Given the difficult choice it's hoping it will not have to make, we believe the markets would rather the Fed lean harder toward preventing further inflation, hence the negative reaction to Chair Powell's comments.
- **In the days following the Fed's meeting, the Bureau of Labor Statistics released the April nonfarm payrolls report displaying 428,000 new jobs added to the economy.** With an unemployment rate 3.6% and year-over-year average hourly wage gains of 5.5%, this report fueled further inflationary concerns and questions as to whether the Fed is still behind the curve on fighting inflation.

In summary, we believe given further inflationary pressures, the Fed will be raising rates at each of the remaining five meetings between now and the end of December, likely closing out the year with a lower bound on the federal funds target range of 3.00%. We also believe given this pace of rate hikes combined with that of a balance sheet reduction, a realistic year-end target on the 10-year U.S. Treasury yield is 3.50%.

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Tom oversees investment and mutual fund development and the sub-adviser selection process. He heads Transamerica's investment thought leadership with advisors, clients, and media. Tom has more than 30 years of investment experience and has managed large mutual funds and sub-advised separate account portfolios. Tom holds a bachelor's degree in political science from Tulane University and an MBA in finance from the Wharton School at the University of Pennsylvania.

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