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Markets and Economy

Fed raises rates, but sparks broad market rally by ruling out 75-bps hikes

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Boston - As widely expected, the Federal Open Market Committee (FOMC) raised the federal funds rate by 50 basis points (bps) at its May 3-4 meeting, to a target range between 0.75% and 1%. But the real headline — and by far the most important thing —was Fed Chair Jerome Powell's statement that the Fed is not "actively considering" steeper hikes of 75 bps.

Powell made clear at his press conference that the Fed is concerned about inflation, and is in a tightening mode. That includes the decision to begin quantitative tightening (QT), starting at $47.5 billion per month of reduction in its portfolio of Treasury and mortgage-backed securities (MBS), and increasing to $95 billion after three months.

Risk markets rallied sharply in response to Powell's comments on May 4. For the previous two weeks, there had been much discussion in the financial markets about the potential for a 75-bps hike. By clipping that possibility from the distribution of outcomes — a tail risk, if you will — the Chair sparked a broad rally in risk markets.

On May 4, equities surged and foreign currencies gained sharply against the U.S. dollar. In the bond market, we witnessed a significant "bull steepening." At the long end of the curve, the 30-year Treasury remained largely flat, while the front end fell by 14 bps.

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Bottom line: The Fed is quite clear that it needs to continue tightening to rein in inflation, and anticipates that more volatility will be part of the process. Powell said that 50-bps rate hikes are likely at the next FOMC meetings in June and July. But for one day at least, by taking the prospect of a larger hike off the table, Powell gave the markets a reason to cheer.

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