FED WATCH: THE WAITING IS THE HARDEST PART

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In what was a widely expected outcome, the Fed raised the Fed Funds Rate by another quarter point today. The "new" Fed Funds trading range now stands at 5%–5.25%, its highest level since 2007. Now comes the hard part…waiting for what comes next from Powell & Co.

With an astonishing 500 basis points (bps) in rate hikes now in the books, the money and bond markets are currently operating under the assumption that Fed policy will now go into a holding pattern. While the voting members did not outright say as much in their May FOMC policy statement, they did seemingly point investors in that direction. However, it is also important to note that the Fed gave itself some flexibility on this front. In other words, Powell & Co. don't want to get pigeonholed into any type of decision while also providing themselves with some options going forward.

The glaring question when it comes to future monetary policy decisions is: now what? First, the policy makers will take stock of their Volcker-esque rate hikes since last March, weighing incoming economic and inflation data accordingly. Up to now, the economy was showing signs of slowing, and investors could even see zero or negative readings for real GDP in upcoming quarters. However, the Fed is still waiting to witness some visible evidence of the labor market softening. In addition, perhaps taking the place of additional rate hikes, the Fed appears to be also factoring in some restrictive forces occurring from tightening credit conditions, especially following the fallout of the regional banking turmoil.

That leaves us with the inflation side of the equation. Yes, inflation, whether it is measured by CPI, PPI or the Fed's preferred PCE gauge, has also revealed a cooling in price pressures. However, these official government readings for both headline and core inflation remain elevated and well above the Fed's 2% threshold.

Fed officials will probably still emphasize their priority of continuing to bring inflation down, but that doesn't necessarily mean more rate hikes unless the data forces the voting members in that direction. Rather, the monetary policy debate in the markets going forward is more than likely going to be centered on the timing for rate cuts. Presently, that's where the disconnect lies between the FOMC and the money and bond markets. At this juncture, the Fed does not appear to have rate cuts on its radar, let alone the multiple-cut scenario found in the implied probability for Fed Funds Futures.

The Bottom Line

With the Fed apparently now in "pause" mode, investors are going to have to wait and see just how long this part of the policy process lasts. Certainly, the policy makers do not want to get into a position where they have to begin raising rates again, so an extended holding pattern, with no rate cuts, seems to be the more likely scenario going forward. Fed communications from here on out are going to be rather "tricky" because the potential for the markets to misinterpret Powell's intentions is going to be elevated, in my opinion. As a result, heightened volatility in the bond market should remain a part of the investment landscape in the months ahead.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

Fed funds target range : the interest rate band the Federal Open Market Committee decides to implement for the federal funds rate.

Basis point : 1/100th of 1 percent.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Money Market : a market for highly-liquid assets generally maturing in one year or les.

Bond market : The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Paul Volcker : Paul Volcker was an American economist who served as the 12th chairman of the Federal Reserve from 1979 to 1987. During his tenure as chairman, Volcker was widely credited with having ended the high levels of inflation seen in the United States throughout the 1970s and early 1980s.

Inflation : Characterized by rising price levels.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Producer Price Index : weighted index of prices measured at the wholesale, or producer level.

Personal Consumption Expenditures (PCE) : Refers to a measure of imputed household expenditures defined for a period of time.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Volatility : A measure of the dispersion of actual returns around a particular average level.