September FOMC Rate Pause – What's Next?

A Reference Guide for Top of Mind with SIFMA Insights

September 2023

Key Takeaways

This is a Reference Guide to accompany the Top of Mind with SIFMA Insights podcast, "September FOMC Rate Pause – What's Next" Inside, we define terms and provide charts for topics we discussed including:

- **Fed Funds Rate**: Currently 5.25%-5.50%. Interest rate at which banks lend money to each other, typically on an overnight basis. Raising the target rate reduces the money supply and causes other market rates to rise, dampening consumer and business spending, slowing economic activity, and reducing inflation.
- **Inflation**: Currently, CPI 3.7%/Core CPI 4.4%/PCE 3.3%/Core PCE 4.2%. Reflected quantitatively by an increase of an average price level of a basket of selected goods and services in an economy and represents the rate of decline of purchasing power of a given currency over some period of time.
- **Credit Tightening**: The regional bank turmoil in March led to a widening of credit spreads for regional banks. Wider spreads increase the cost of borrowing, thereby limiting lending. Regional banks spreads increased 77.1% from the low for the year early in the turmoil and peaked at +123.8%. Spreads remain elevated today for regional banks, +42.6% to the low but -36.3% to the peak.

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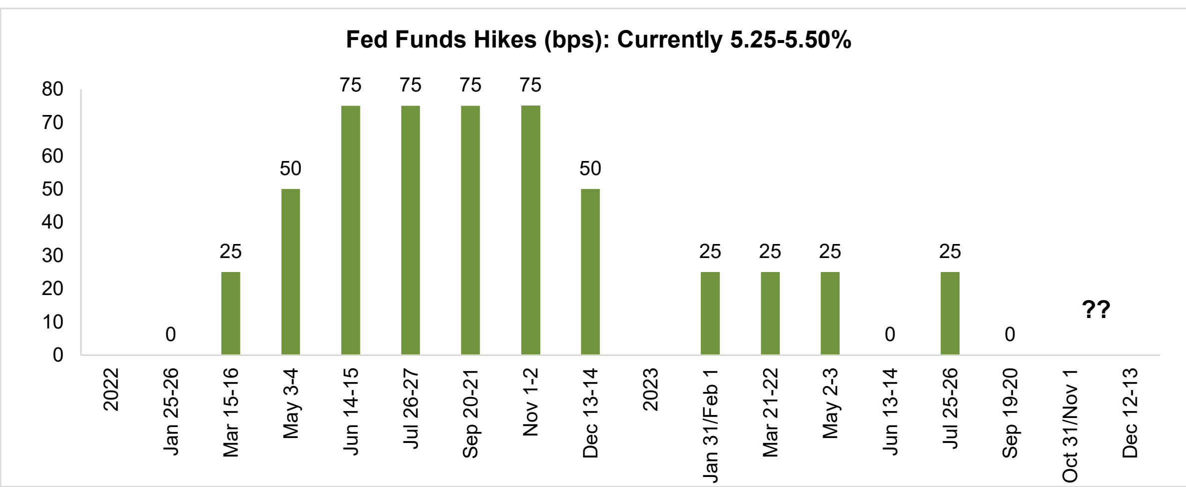
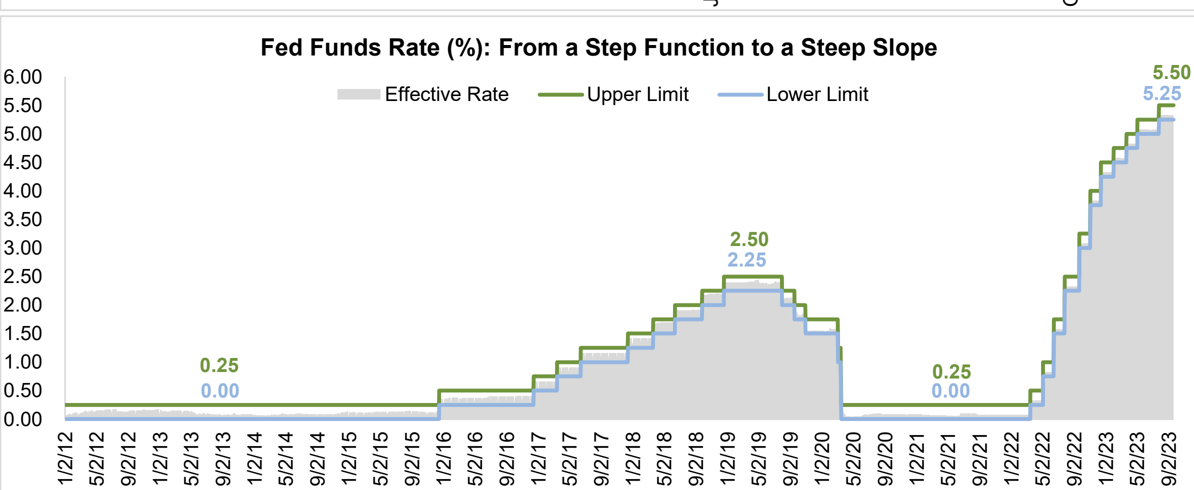
Federal Funds Rate (Fed Funds): *The interest rate at which banks and other depository institutions lend money to each other, typically on an overnight basis.*

The Fed uses open market operations, a monetary policy tool, to buy and sell U.S. Treasury securities on the open market to align the actual Fed Funds rate with the Federal Open Market Committee's (FOMC) target rate. To lower its target rate, the trading desk at the Federal Reserve Bank of New York (FRBNY) buys securities to increase the supply of reserves held by banks, paid for by crediting these banks' reserve accounts. The banks can use those reserves to convert into loans, adding to the money supply and putting downward pressure on the Fed Funds rate. Short and long-term market interest rates directly or indirectly linked to the Fed Funds rate also tend to fall, encouraging consumer and business spending, stimulating economic activity, and increasing inflationary pressures. Conversely, to raise the FOMC's target rate, the FRBNY trading desk sells Treasuries, collecting payments from banks by withdrawing funds from their reserve accounts. This reduces the money supply and puts upward pressure on the Fed Funds rate. Other market rates then rise, dampening consumer and business spending and, therefore, slowing economic activity and reducing inflationary pressures.





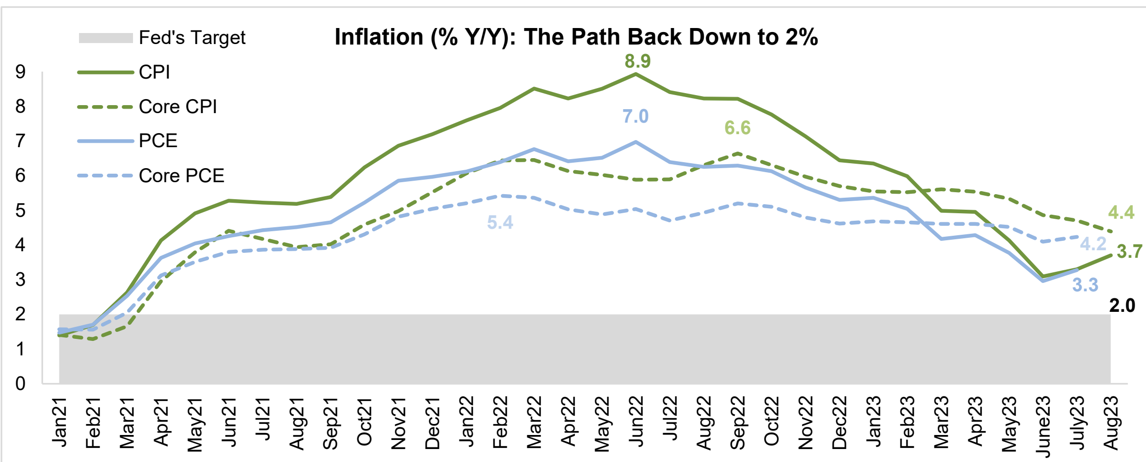
Source: Bloomberg, SIFMA estimates (as of 9-20-23)

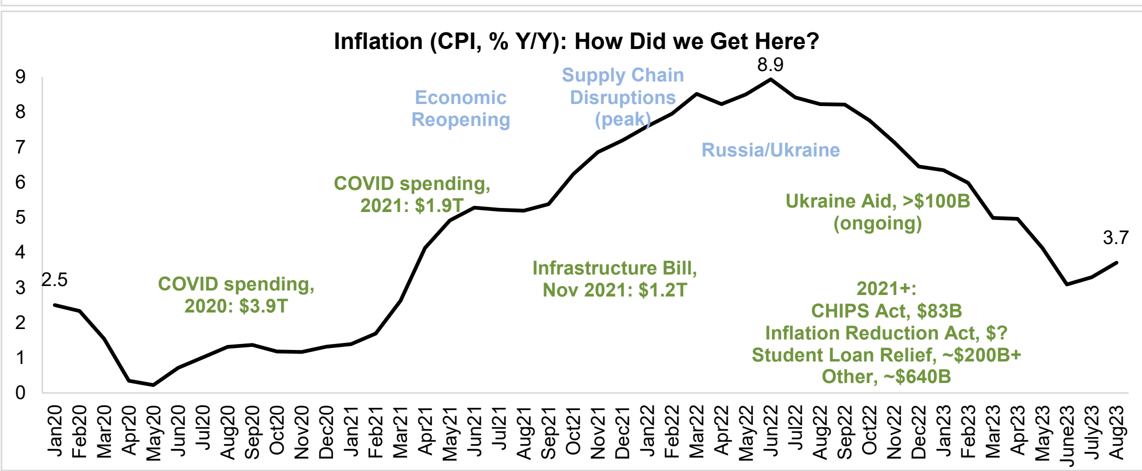
Inflation: *An increase of an average price level of a basket of selected goods and services in an economy, representing the rate of decline of purchasing power for a given currency over some period of time.*

There are multiple components of the inflation equation, with pressure points bucketed as: supply side, demand side, and the labor component. Common measures of inflation are:

- CPI – headline inflation; measures the change in direct expenditures for all urban households for a defined basket of goods and services (three largest components are housing, transportation, and food/beverages)
- PCE – the metric the Fed monitors for monetary policy – measures the change in the prices of goods and services consumed by all households and nonprofit institutions serving households
- Core CPI or PCE – makes adjustments to remove the source of the noise in the price data, i.e. food and energy, to get a measure of the underlying component of inflation

There are several differences between each measure. For example, basket composition for CPI is based on household purchases (includes imports) whereas PCE is based on what businesses are selling (includes capital goods). Other differences include calculation methodologies, accounting for basket changes, etc.

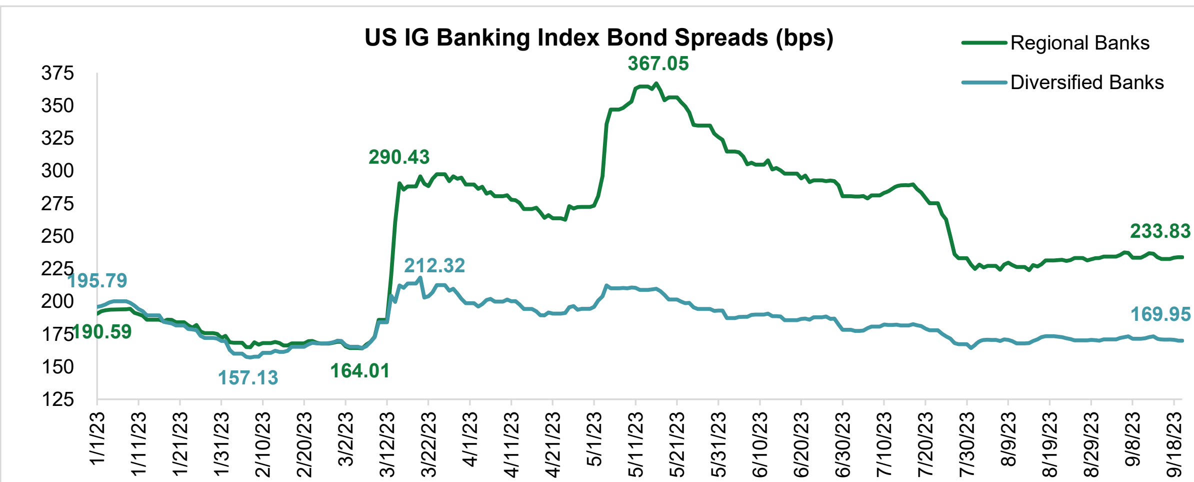




Source: FRED, IMF, NY Fed, SIFMA estimates (CPI/Core CPI as of July, PCE/Core PCE as of June)

Credit Tightening: The regional bank turmoil that began in March led to credit tightening for corporate and consumer borrowers. At the beginning of the year, credit spreads were declining, -13.9% for regional banks and -19.7% for diversified (or large) banks. After the collapse of SVB, investment grade credit spreads widened, widening further after the sale of First Republic. Regional banks spreads increased 77.1% from the low for the year early in the turmoil and peaked at +123.8%. Diversified banks initially rose 35.1% and peaked at +38.9%. Spreads remain elevated today for regional banks, +42.6% to the low but -36.3% to the peak. Yet, diversified banks are only +8.2% to the low (-22.1% to the peak) and down 13.2% to the start of the year.

Wider spreads increase the cost of borrowing, thereby limiting lending. Lending is further hindered as banks tighten credit standards for borrowers, shrinking the borrowing pool.



Source: Apollo Chief Economist, Bloomberg, SIFMA estimates

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