Bell Bank

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Commercial Insights

What a Fed Pause Means for Businesses

Businesses have been navigating one of the fastest Fed tightening cycles in history amid high inflation rates. However, this may be changing as the Fed chose to forgo raising interest rates at their recent June meeting. Despite this pause, the Fed has signaled that they currently expect some further interest rate increases to be appropriate, albeit at a slower pace.

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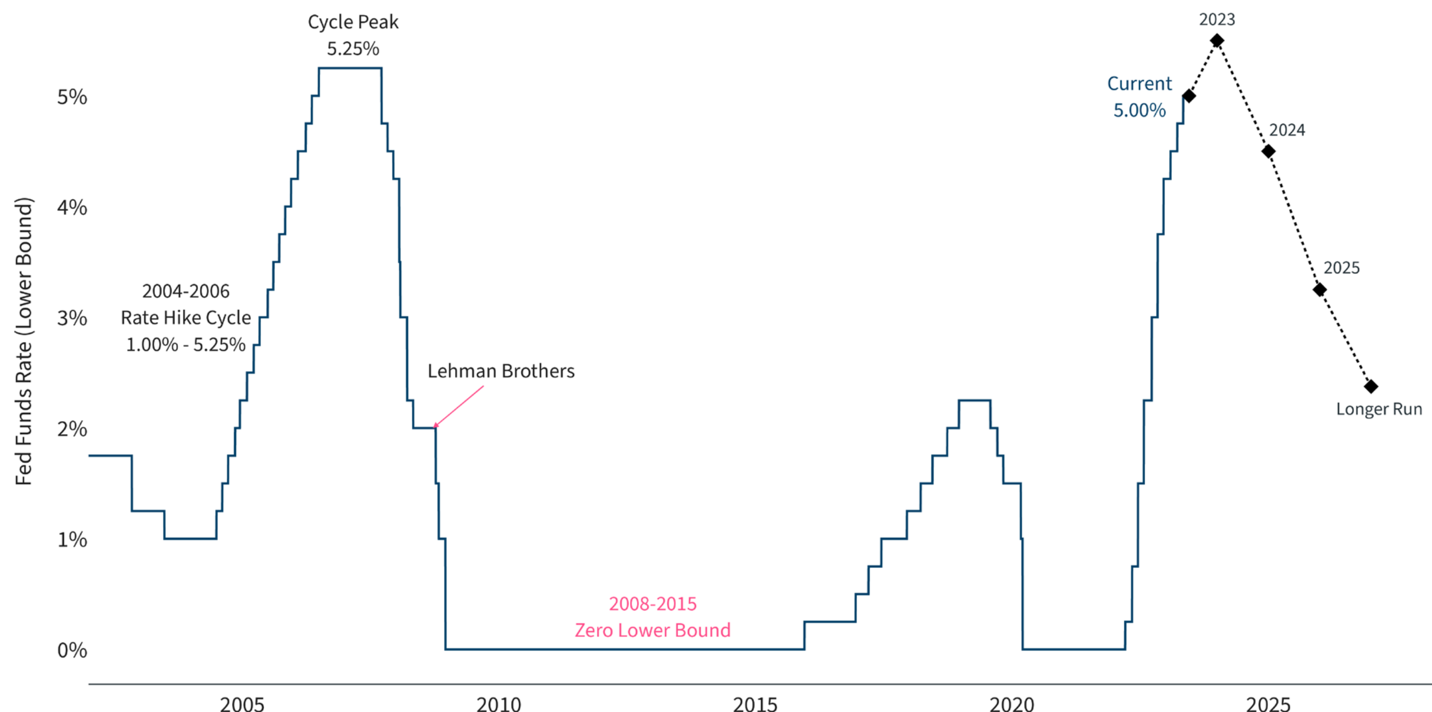
The Fed has been raising interest rates since early last year and, through May, has increased policy rates ten times from 0% to 5%. While the goal of Fed officials has been to fight inflation, they also understand that doing so increases borrowing costs for businesses and households, creating financial instability and slowing the economy. Given this ongoing economic uncertainty, what does a potential reversal in Fed policy mean for business leaders in the months ahead?

Inflation remains sticky

The primary reason the Fed has been raising rates is to slow the worst inflation rates in four decades. It's no secret that the prices of goods and services increased rapidly over the past few years due to supply chain disruptions, higher energy prices due to the war in Ukraine, rising rents, and more. At its worst point, the Consumer Price Index (CPI) increased 9.1% from the previous year while the Producer Price Index (PPI) for commodities, which measures the prices businesses pay for their inputs, jumped over 22%.

Federal Funds Rate

Target range lower limit and FOMC median rate expectations (dotted line)



Latest data point is June 2023
Sources: Clearnomics, Federal Reserve

These price increases are not something that individuals or businesses have experienced since the early 1980s, especially because inflation was unusually low in the years after the 2008 financial crisis. If this weren't challenging enough, businesses also face ongoing pressure from a tight labor market, slowing economic growth, political challenges in Washington, and global uncertainty. Some business leaders may feel as if they are being squeezed from all sides.

For the Fed, the biggest concern is that inflation can be "sticky." This occurs when price increases lead to expectations of more price hikes, which lead to higher wages due to the higher cost of living. This, in turn, boosts demand and increases prices further. Left unchecked, this can lead to a self-sustaining inflationary spiral as it did in the 1970s and early 1980s. This is the primary motivation for the Fed's swift action over the past year.

Fortunately, many inflation measures have fallen from their highs. CPI has decelerated to "only" 4.0% year-over-year, while PPI has slowed to 1.1%. Core inflation remains problematic, as does the pace of service price increases. Still, broad improvements have allowed the Fed to pause interest rate increases at their most recent meeting and evaluate the state of the economy.

While the Fed did not increase interest rates in its most recent meeting, it projected that more interest rate increases may be appropriate in the future. Whether the Fed does so depends heavily on how it interprets the economic data with respect to its so-called dual mandate of maintaining stable prices and maximum employment. Traditionally, the relationship that describes this is referred to as the "Phillips Curve." It states that when unemployment is low one might expect inflation to be high, and vice versa. In other words, it suggests that the only way for the Fed to beat inflation is by destroying jobs and risking a recession.

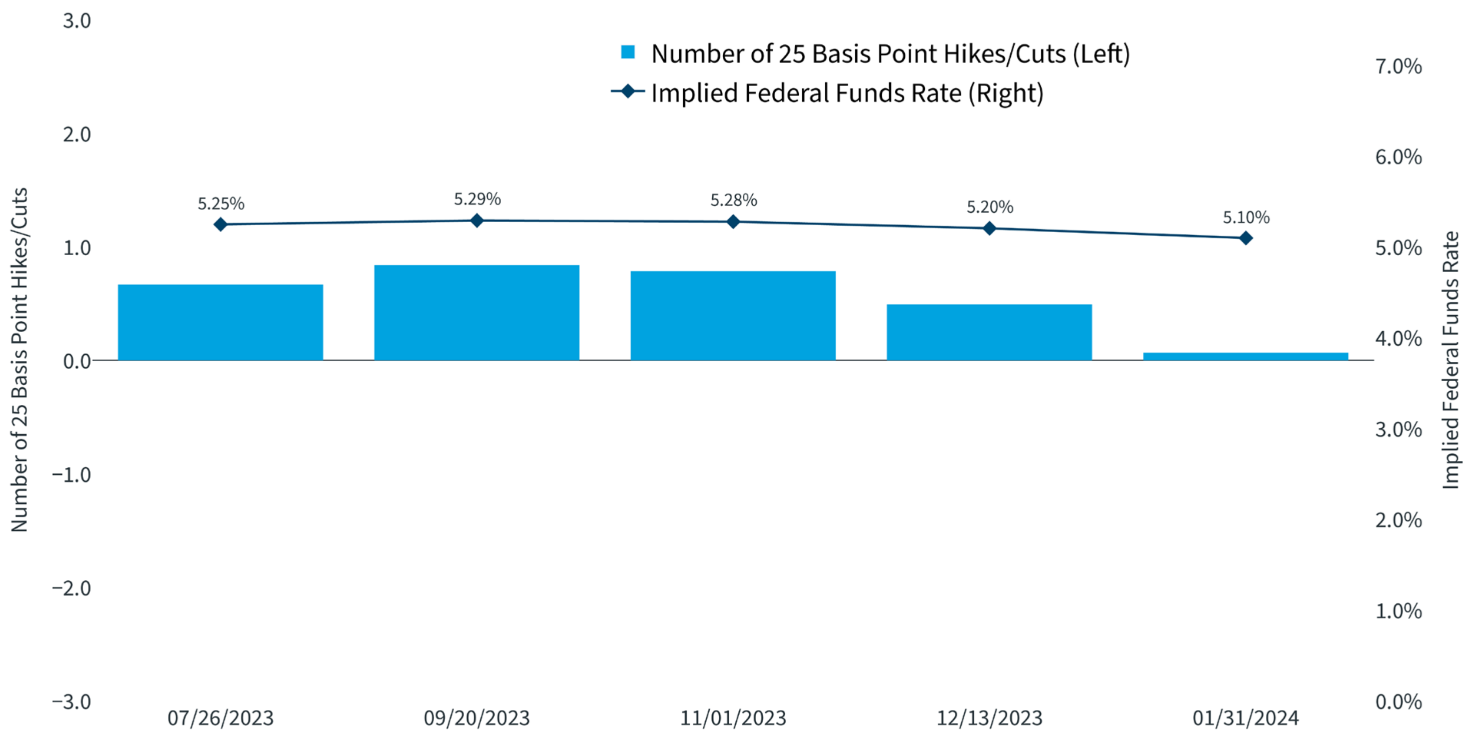
However, this has not proven to be the case this time around. The fact that unemployment remains extremely low by historic standards, especially in many Midwestern states which have the lowest jobless rates in the nation, gives the Fed some policy leeway. Additionally, many economists and investors have been expecting a recession, but so far none has materialized. The Fed's choice to keep interest rates stable in June suggests that they are approaching a sufficiently high level of interest rates and may consider holding rates steady for a more prolonged pause soon.

The impact of a rate pause on businesses

Regardless of the ultimate level of interest rates, business leaders should continue to carefully consider the impact of interest rates on their strategic plans. Despite the Fed's rate hikes and projections for further increases, market-based interest rates have already

Fed Funds Futures Implied Rates

Implied fed funds rates and numbers of hikes/cuts at each Fed meeting



Sources: Clearnomics, Bloomberg

stabilized this year. The 10-year Treasury yield, for instance, has fallen from its peak last October of almost 4.25% to 3.8% today. While this is much higher than the pandemic low of only 0.5%, it suggests that rates are approaching their terminal level.

So, while borrowing costs may be higher than just a year ago, a Fed pause may create more stable rates that allow businesses to make strategic decisions with more confidence. Weighing the short-term costs against the long-term gains of these projects is more important than ever. For example, the benefits of automation and upgrading equipment may be especially important at a time when labor costs continue to rise. For projects that already made sense in a higher-rate environment, a Fed pause should only further support the growth plans of many businesses.

While the Midwest's concentration of manufacturing, industrial, and agricultural companies does make it economically sensitive, it is also less sensitive to the challenges of the most rate-sensitive sectors such as tech. Stable rates could help to push many companies' strategic plans back on track. Those businesses with access to attractive financing opportunities, strong banking relationships, and trusted guidance should continue to carefully consider expansion and growth opportunities to maintain their competitiveness in the years to come.

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