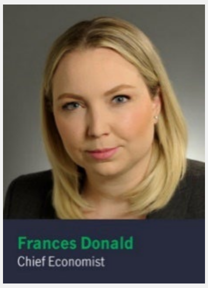

The U.S. Federal Reserve kept rates steady at its June meeting. Our base case is that the Fed will indeed raise rates in July, with the obvious caveat that a deterioration in inflation or employment data could make the Fed more inclined to hold rates steady for another meeting. Frances Donald, Global Chief Economist and Strategist, Multi-Asset Solutions Team, discusses three main implications in this market note.

Beyond the Fed's hawkish "pause": three macro elements to consider

After aggressively raising rates by a cumulative 500 basis points (bps) since March of last year, the U.S. Federal Reserve (Fed) left its policy rate unchanged at 5.25% at its June meeting. The accompanying statement mentions that holding the target rate steady this month will allow the Federal Open Market Committee (FOMC) to gather "more information" to determine if additional monetary tightening is needed. However, FOMC members also signaled their intention to raise rates two additional times by the end of the year. All in all, the underlying message from this decision can basically be summarised as: "better, but higher and longer."

A better economy, as the summary of economic projections mostly revealed an improved economic outlook: stronger, but still weak, economic growth in 2023 with a modest rebound in 2024, an unemployment rate that rises by less than expected, to 4.5% by the end 2024, and more persistent core inflation.

Higher rates, as the FOMC's famous "dot plot" implies a material risk of a rate hike as soon as July, and potentially another one later this year. Our base case is that the Fed will indeed raise rates in July, with the obvious caveat that a deterioration in inflation or employment data could make the Fed more inclined to hold rates steady for another meeting

But most importantly, **higher rates for longer**. In his press conference, Fed Chair Powell mentioned that risks to inflation "are to the upside" and that interest rate cuts are probably "a couple years out". In other words, Powell pushes back against markets pricing in early rate cuts.

From a global perspective, none of this is new. Over the past year, we've noticed that central banks have demonstrated two substantial biases. First, moving earlier and faster in the presence of inflation is better than moving late and slow (i.e., front-loading rates is preferable). Second, we now see that there's a critical distinction between pausing and pivoting. For instance, the Reserve Bank of Australia (RBA) and, more recently, the Bank of Canada (BoC) resumed hiking rates after indicating they were pausing.

The macro context surrounding the RBA and the BoC's respective decision to raise rates is key: sustained, elevated levels of inflation, which are similar to what we're seeing in the U.S. economy and many parts of the world.

Yet, the most important question for economic forecasters doesn't relate to rate hikes or how much higher rates can go, but what the shape of the next interest-rate easing cycle will look like. While the mainstream narrative will likely focus on whether the Fed will hike again at its next meeting on 28 July, we think the more important question for investors is *how* and *when* the central bank will respond to the expected slowdown in U.S. growth.

Looking back, we know that the Fed responded to the last three recessions by announcing interest-rate cuts shortly after signs of economic distress became observable. It could be slightly different this time. While we still expect the Fed to begin cutting rates in 2024, we think it will be less inclined to ease relative to past cycles, particularly over the next 6 to 12 months. In our view, how the next easing cycle could look—and the extent to which rates could fall—will depend on three characteristics of the coming recessionary environment.

1. **Prices may continue to fall, but 2% inflation remains elusive**

We have fairly high conviction that U.S. headline inflation will fall to around 3% by year end, but the odds of inflation hitting 2% or below in the near term are lower than they've been in the past. Indeed, we continue to believe that supply-side issues and global factors such as deglobalization, political conflicts, and increasingly frequent and severe weather events are making the hoped-for return to 2% inflation more challenging. This is relevant not just to the Fed, but central banks globally, many of whom might need to make a difficult choice:

- Accept that there's a limit to how far monetary policy—specifically, interest rates—can influence price levels and concede that a higher inflation target is necessary, or

- Actively pursue their respective inflation target at the expense of growth, recognizing that such a policy choice could potentially lead to more frequent recessions and a structurally lower growth profile.

2. **Return of the two-speed economy**

A two-speed economy, in which the manufacturing/goods segment of the economy is running in a deeper contractionary space than the services and labor economy, is likely to make an unwelcome return to the United States. Crucially, while we expect the U.S. unemployment rate to rise in the coming year, it's likely to rise by less than it did during past recessions. In our view, labor supply will continue to be an issue—a function of structural changes in the economy—and it's likely to affect the services sector the most. That said, while we expect the jobless rate to remain relatively low, we could see other challenges within the labor market (e.g., weak *hours* worked and below-trend wage growth). This may give the Fed and other central banks some cover to maintain a relatively *less* accommodative approach to monetary policy than they had done in past recessions. This is one reason why we believe that the Fed's next rate-cut cycle may not go as far as previous easing cycles.

3. **A recession may be on the horizon, but we could still see signs of excesses in asset prices**

Recession concerns may be elevated, but key U.S. stock indexes seem to be telling a different story, thanks to the exuberance brought about by progress in the artificial intelligence space. Look deeper, however, and the cracks begin to show. It's still too early to write off the U.S. regional banking crisis, which continues to percolate beneath the surface—the scale of its impact on the commercial real estate sector has yet to be fully understood.

Unlike past economic cycles in which signs of banking system stress and stock market declines would convince the Fed to reverse its tightening policies and thereby trigger the Fed put, this time could be different. The default setting may no longer apply and markets might need to recalibrate their expectations.

As we've argued previously, central banks' approach to policymaking has evolved and falls in asset prices could well have become a *feature* of central banking thinking rather than a *bug*. As such, we believe the Fed could be less motivated to implement ultra-easy policy in the face of market events when compared with the past. The macro backdrop is in the process of becoming more complicated and caution is certainly warranted.

Disclaimer

Investing involves risks, including the potential loss of principal. Financial markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. These risks are magnified for investments made in emerging markets. Currency risk is the risk that fluctuations in exchange rates may adversely affect the value of a portfolio's investments.

The information provided does not take into account the suitability, investment objectives, financial situation, or particular needs of any specific person. You should consider the suitability of any type of investment for your circumstances and, if necessary, seek professional advice.

This material is intended for the exclusive use of recipients in jurisdictions who are allowed to receive the material under their applicable law. The opinions expressed are those of the author(s) and are subject to change without notice. Our investment teams may hold different views and make different investment decisions. These opinions may not necessarily reflect the views of Manulife Investment Management or its affiliates. The information and/or analysis contained in this material has been compiled or arrived at from sources believed to be reliable, but Manulife Investment Management does not make any representation as to their accuracy, correctness, usefulness, or completeness and does not accept liability for any loss arising from the use of the information and/or analysis contained. The information in this material may contain projections or other forward-looking statements regarding future events, targets, management discipline, or other expectations, and is only current as of the date indicated. The information in this document, including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Manulife Investment Management disclaims any responsibility to update such information.

Neither Manulife Investment Management or its affiliates, nor any of their directors, officers or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained here. All overviews and commentary are intended to be general in nature and for current interest. While helpful, these overviews are no substitute for professional tax, investment or legal advice. Clients should seek professional advice for their particular situation. Neither Manulife, Manulife Investment Management, nor any of their affiliates or representatives is providing tax, investment or legal advice. This material was prepared solely for informational purposes, does not constitute a recommendation, professional advice, an offer or an invitation by or on behalf of Manulife Investment Management to any person to buy or sell any security or adopt any investment strategy, and is no indication of trading intent in any fund or account managed by Manulife Investment Management. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Diversification or asset allocation does not guarantee a profit or protect against the risk of loss in any market. Unless otherwise specified, all data is sourced from Manulife Investment Management. Past performance does not guarantee future results.

Manulife Investment Management

Manulife Investment Management is the global wealth and asset management segment of Manulife Financial Corporation. We draw on more than a century of financial stewardship to partner with clients across our institutional, retail, and retirement businesses globally. Our specialist approach to money management includes the highly differentiated strategies of our fixed-income, specialized equity, multi-asset solutions, and private markets teams—along with access to specialized, unaffiliated asset managers from around the world through our multimanager model.

This material has not been reviewed by, is not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the following Manulife entities in their respective jurisdictions. Additional information about Manulife Investment Management may be found at manulifeim.com/institutional

Australia: Manulife Investment Management Timberland and Agriculture (Australasia) Pty Ltd, Manulife Investment Management (Hong Kong) Limited. **Canada:** Manulife Investment Management Limited, Manulife Investment Management Distributors Inc., Manulife Investment Management (North America) Limited, Manulife Investment Management Private Markets (Canada) Corp. **Mainland China**: Manulife Overseas Investment Fund Management (Shanghai) Limited Company. **European Economic Area** Manulife Investment Management (Ireland) Ltd. which is authorised and regulated by the Central Bank of Ireland **Hong Kong:** Manulife Investment Management (Hong Kong) Limited. **Indonesia:** PT Manulife Aset Manajemen Indonesia. **Japan:** Manulife Investment Management (Japan) Limited. **Malaysia:** Manulife Investment Management (M) Berhad 200801033087 (834424-U) **Philippines**: Manulife Investment Management and Trust Corporation. **Singapore:** Manulife Investment Management (Singapore) Pte. Ltd. (Company Registration No. 200709952G) **South Korea:** Manulife Investment Management (Hong Kong) Limited. **Switzerland:** Manulife IM (Switzerland) LLC. **Taiwan:** Manulife Investment Management (Taiwan) Co. Ltd. **United Kingdom:** Manulife Investment Management (Europe) Ltd**.** which is authorised and regulated by the Financial Conduct Authority **United States:** John Hancock Investment Management LLC, Manulife Investment Management (US) LLC, Manulife Investment Management Private Markets (US) LLC and Manulife Investment Management Timberland and Agriculture Inc. **Vietnam:** Manulife Investment Fund Management (Vietnam) Company Limited.

Manulife, Manulife Investment Management, Stylized M Design, and Manulife Investment Management & Stylized M Design are trademarks of The Manufacturers Life Insurance Company and are used by it, and by its affiliates under license.