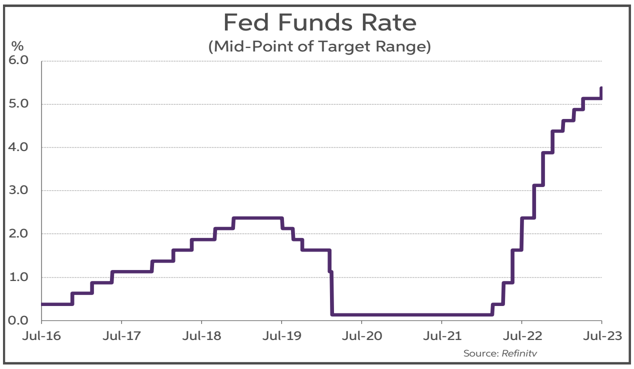
Fed Watch

AIB Treasury Economic Research Unit

27th July 2023

Fed hikes by 25bps, keeps its options open



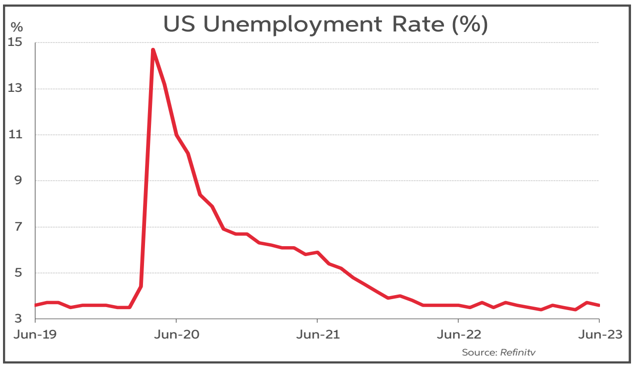
As widely expected, the Fed hiked US rates by 25bps at the conclusion of its policy meeting yesterday, bringing the target range for the funds rate up to 5.25-5.50%. The Fed has enacted 525bps worth of rate increases since it commenced tightening policy in March 2022. The decision to raise rates by 25bps was unanimous. **The market's view is that the Fed will not raise rates any further** given that there has been a marked easing in inflation in recent months.

Good CPI reports for May and June, in particular, have given the market confidence that interest rates may have reached a peak following yesterday's hike. CPI data **show a big drop in the annual headline rate from 4.9% in April to 4% in May and 3% in June.** The core CPI inflation rate has also started to moderate, falling from 5.5% in April to 5.3% in May and 4.8% in June. The core CPI rose by just 0.2% in June, the smallest monthly rise since August 2021. Furthermore, annual producer price inflation fell to just 0.1% in June, with the core rate declining to 2.4%. Meantime, the Fed's preferred inflation measure, core-PCE, is forecast to see its annual rate decline to 4.2% in June from 4.6%, when the data are released tomorrow.

However, **Fed Chair Powell did not give any indication yesterday that rates have peaked and kept the option open of hiking again. He commented that getting inflation back down to its 2% target "is likely to require a period of below trend growth and some softening in labour market conditions".** Indeed, the Fed's latest rate projections, or dot-plot, which were published at the June meeting, showed the median Fed projection was for rates to be raised to a 5.50-5.75% range by end 2023, implying they will do one more rate hike in the coming months. There was nothing from the Fed yesterday to suggest that it has altered this view on rates.

The latest set of Fed quarterly macro forecasts were also published in June. The projection is for the core-PCE inflation rate to fall to 3.9% in Q4 2023, and then to 2.6% by Q4 2024, and to 2.2% in Q4 2025. In our view, the Q4 2023 forecast could well be undershot to a significant degree. Indeed, **the annual core-PCE rate could drop to circa 3% this winter. However, this may not be in time to prevent a further rate hike this autumn, especially if activity data do not point to a clear slowing of momentum in the economy.** In terms of economic activity, the Fed sees GDP growth running at 1.0% y/y in Q4 2023 and 1.1% in Q4 2024 before picking up to 1.8% by Q4 2025. The latest data point to upside risks to the Fed's forecast that GDP growth will slow to 1% y/y by end 2023.

Chair Powell emphasised that the Fed will take a "data-dependent approach" to future policy decisions. He commented that it can afford to be a little patient as well as resolute in this regard, a signal that the Fed is keeping all options open. Thus, **we are surprised that the markets are assigning such a low probability to a further Fed rate hike.** Future contracts are pricing in that rates may rise by circa 10bps this autumn to 5.43% which is still within the new target range for the Fed Funds of 5-25-5.50%, implying no further hike in rates.



Further out, markets are anticipating a considerable loosening of policy during 2024, starting possibly as early as March. They expect rates to be cut by 125bps to 4.125% by the end of next year, with a further 50bps of easing anticipated in 2025. **The Fed's view, as set out in its June dot-plot, is that rate cuts will be slower to materialise than this in the near term, but that significant policy easing is still likely by end 2025**. The median dot-plot shows the Fed expects rates to be lowered to 4.625% by Q4 2024 and to 3.375% by Q4 2025. This would represent 200bps of easing in 2024-25, based on the current level of the Fed funds rate of 5.375%.

The market reaction to the Fed meeting was very muted across the board. It stuck to its guns that the Fed is done. However, this will likely require below trend growth, softening labour market, as well as a continued fall in inflation.

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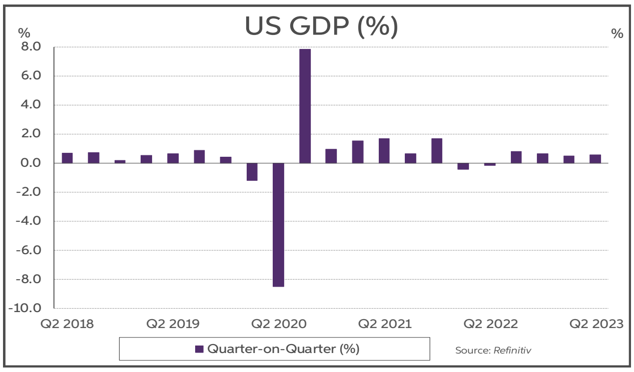
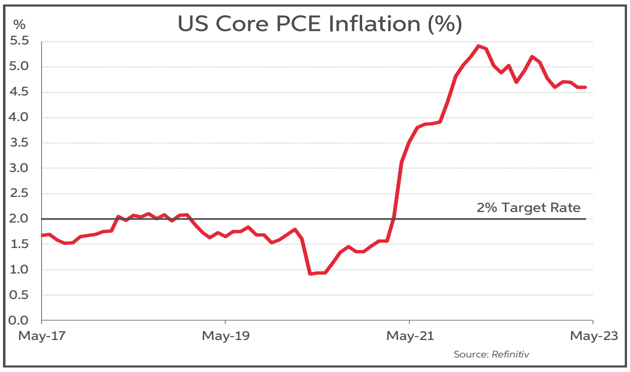
Strong, resilient US economy in H1 2023

Having expanded by 2.0% annualised in Q1, GDP grew by 2.4% in annualised terms in Q2. Meantime, real final sales rose by 2.3% annualised in Q2, down from 4.2% in Q1. Overall, the data show that the US economy remained strong and resilient in Q2. Regarding the breakdown for Q2, consumption rose by 1.6% in the quarter (compared to 4.2% in Q1), contributing 1.1 percentage points (p.p.) to GDP. Similarly, fixed investment added 0.8 p.p. to the total. Government spending boosted growth by a further 0.5 p.p.. Meanwhile, changes in inventories offset the 0.1 p.p. contribution to output from external trade.



The limited survey data available for July, are consistent with a slowdown in activity at the start of Q3. The flash composite PMI reading remained in expansion territory in July, but fell for the second consecutive month, to 52.0 from 53.2. The services PMI has moved lower in the past two months, but stayed above the key 50 threshold in July. The services sector has now been in expansion mode for the past six months. In contrast, the flash manufacturing PMI printed in contraction territory for the eighth time in nine months, in July. However, consumer sentiment did improve in July. The Conference Board measure rose to 117.0, its highest level in two years. Meantime, the University of Michigan survey - which places a greater emphasis on household finances and spending plans - also hit its highest point in two years in July, though it still remains at a subdued level.

The rise in consumer confidence can partly be explained by the clear disinflationary path that has now taken hold in the US. Headline CPI inflation fell to 3.0% in June, down from 4.0% in May, and well below its peak of 9.1% in June 2022, helped by lower energy prices. Food price inflation is clearly moderating, though the annual rate remains high at 5.7%. **Meantime, core inflation is proving stickier, but has moved lower in recent months**. Core-CPI declined to 5.7% last December, having peaked at 6.6% in September, but remained in a 5.5-5.7% range in early 2023, before falling to 5.3% in May. It then declined to 4.8% in June, its lowest level since October 2021. Similarly, headline PCE inflation eased to 3.8% in May, down from 5.3% last December, but core-PCE has been in a narrow 4.6 -4.7% corridor in the six months to May. However, core-PCE is forecast to fall to 4.2% in June. Overall, the Fed expects core-PCE inflation to move down slowly towards the 2% target level over the next couple of years, falling to 2.2% by Q4 2025.



In terms of the labour market, conditions have softened slightly, but remain very tight overall. Payroll growth remained robust during the first half of the year, rising by an average of 278k per month. However, June's 209k increase, was the lowest since payrolls unexpectedly fell in December 2020. Meantime, the number of job openings stood at 9.8m in May, down from 11.2m at the end of 2022. The unemployment rate stood at 3.6% in June, and has been confined to a very low 3.4-3.7% range now since March 2022. Average earnings growth maintains solid momentum, rising by 0.4% per month in Q2. In year-on-year terms, average earnings stood at 4.4% in June, down from 4.8% in December, and a peak of 5.9% in March 2022.

To surmise, the US economy continued to perform well in H1. More recently, data have been mixed, with some signs emerging that growth may be softening. Furthermore, the impact of elevated levels of inflation and significant monetary policy tightening over the past year are still working their way through the economy. **Looking ahead, stresses in the US banking system this spring are likely to lead to tighter credit conditions, which will be an added drag on economic activity**. Indeed, NFIB small business surveys indicate that firms have already been experiencing tighter credit conditions since last summer. The CRE market is also on a clear weakening path. Overall, the US economy is set to grow more slowly this year and next, have expanded by 2.1% in 2022. **The IMF sees GDP growing by 1.8% in 2023, and 1% in 2024.** Meanwhile the Fed expects growth to slow to 1.0% y/y by Q4 2023, pointing to an average growth rate above 1.5% this year, with GDP growth averaging close to 1% in 2024. **The risks to the economy are to the downside,** especially from a possible marked tightening in credit conditions, lagged effects of substantial monetary policy tightening, more persistent inflation and weaker global activity.

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