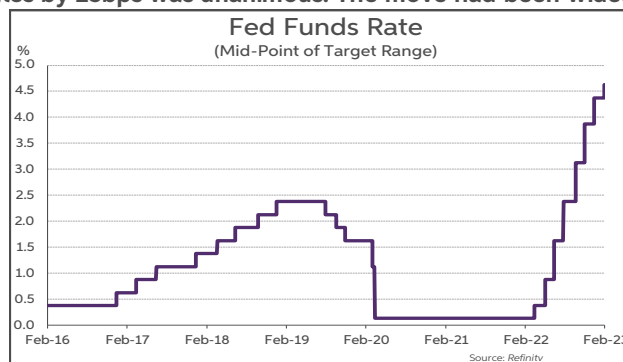


Fed slows rate hikes to 25bps, just a couple more to come

After the US Federal Reserve had implemented four consecutive 75bps rate hikes between June and October, the December FOMC meeting saw it move back down to a 50bps rate increase. **In its first meeting of 2023, the Fed slowed the pace of hikes even further, when it announced a 25bps rise yesterday.** This brings the target range for the Fed funds rate up to 4.50-4.75%. **The decision to raise rates by 25bps was unanimous. The move had been widely signalled in advance by Fed officials, so it came as no surprise.** The Fed has now enacted 450bps worth of rate increases since it commenced tightening policy last March.

Fed Chair Powell indicated at the post-meeting press conference that “a couple of more rates hikes” will be required to attain a stance of monetary policy that is sufficiently restrictive to return inflation to its 2% target over time. This is in line with the signals from the Fed over the past couple of months that rates will need to rise above 5% in order to achieve its inflation target.

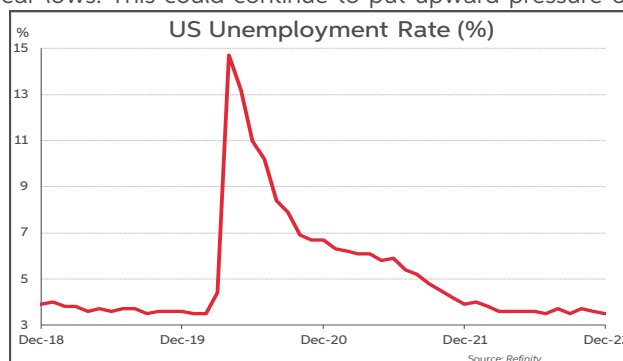


In this regard, the latest set of official interest rate projections, or dot-plot, which were provided by the Fed at its December meeting, showed that it sees rates peaking at 5.125% this year. We would highlight that only two of the nineteen FOMC members at that time saw rates peaking below 5%, with ten seeing rates getting to 5.125%, and seven others projecting that rates would top out above this level in 2023. This suggests that **there is a strong bias within the FOMC to take rates above 5% in the coming months.** Meanwhile, the dot-plot also showed that the Fed sees rates ending 2023 at 5.125%, and then falling to 4.125% by end 2024 and 3.125% at end 2025. Senior Fed officials have remarked recently that it is important they “stay the course” and maintain a restrictive policy stance over the next couple of years as it will take time to “get the job done” in terms of bringing inflation back down to 2%.

Markets, though, are not convinced that policy will need to be as restrictive as the Fed is indicating. Futures contracts are still pricing in that rates will peak at 4.875% in the spring, before being cut by 50bps to 4.375% by end 2023. Further out, the markets expect that the Fed will cut rates by close to a further 150bps to circa 3% by end 2024, which is over 100bps lower than the Fed’s projection. Fed Powell stated he was not going “to try to persuade people” who have different forecasts, but guided the Fed “will need to keep rates higher for longer”.

A key reason for the hawkish Fed view is that it believes inflation will prove sticky, as revealed in its December forecasts. The projections are for the headline and core PCE rates to be at 3.1% and 3.5%, respectively, in Q4 2023, and still above target at 2.5% by end 2024. The Fed is concerned in particular that the labour market remains “extremely tight”, with the unemployment rate at near 50-year lows. This could continue to put upward pressure on wages, making it difficult for inflation to fall back to 2%.

There has been a marked improvement in inflation, though, in recent months. Indeed, Chair Powell acknowledged that the “disinflationary process has started.” The headline CPI rate declined to 6.5% in December, well below its peak in June of 9.2%. Meanwhile, the core PCE deflator fell to 4.4% in December from 5.2% in September. **Chair Powell cautioned, however, that we are just in the early stages and there is a long way to go in this process.**



Markets rallied following the FOMC meeting while the dollar fell despite the Fed sticking to its guns on the need for monetary policy to remain restrictive for a prolonged period. We expect the Fed to deliver two more 25bps hikes by May before putting policy on hold over the summer. Where rates go after that will depend on the course of the economy, labour market and inflation. Chair Powell noted that “certainty is just not appropriate” in this regard. **We are nearing the end of the Fed’s year-long rate hiking cycle to move policy to an appropriately restrictive stance. Fed policy will now move to a much more data-dependent mode.** A lot will rest on the labour market, which is holding up well despite recent weak consumer spending and manufacturing data, with core inflation and wage data also crucial. In this regard, there will be two labour market reports, and two CPI data releases before the next Fed meeting in March.

US economy expected to see very weak growth in 2023

The US economy grew by 2.1% in 2022, having expanded by 5.7% in 2021. In the first half of last year, volatility in trade and inventories - a hangover from the supply chain issues caused by the pandemic - led to a fall in GDP. However, real final sales to domestic purchasers (which excludes external trade and inventories), increased, indicating that the domestic economy remained in good health. In the second half of 2022, a sharp fall in imports as businesses had already rebuilt their stock levels, boosted the headline GDP figures, while the domestic economy expanded at a more modest pace.

The most recent GDP update for Q4, showed consumer spending continued to grow solidly, increasing by 2.1% in annualised terms. However, most of the strength in consumption was registered in October. Business investment also continued to expand, but there was yet another very sharp fall in residential investment, which contracted by 26.7%. Government spending rose by 3.7% for a second consecutive quarter. Meanwhile, inventory building added 1.5 p.p. to GDP. Overall then, the underlying details of the Q4 GDP report suggest some loss of momentum in the US economy in the quarter.

Similarly, monthly indicators deteriorated sharply at the end of 2022. Retail sales fell by 1% in November, and by 1.1% in December, with the control group measure contracting by 0.7%. Likewise, industrial production declined in November and December. Meantime, activity in the housing sector remains weak, but appears to be bottoming out, having contracted sharply in the second half of 2022.

In terms of the labour market, payrolls rose by a substantial 4.5mn in 2022. However, as the year progressed, the pace of jobs growth slowed somewhat. During the first three quarters of last year, payrolls rose by 418k per month on average, but this fell to 247k in Q4. Furthermore, in December, payrolls grew by just 223k, the lowest monthly rise since December 2020. Against the backdrop of slower job creation, the pace of average earnings growth moderated in Q4. Overall though, conditions in the labour market remain very tight, meaning average weekly earnings were still up 4.6% y/y in December. Elsewhere, the wages component of the closely followed ECI rose by 1% in Q4. The tight conditions in the labour market are also evidenced by the unemployment rate printing below 4% every month since last February, with the jobless rate falling to 3.5% in December.

Meantime, while inflation proved to be much stronger than expected last year, the headline rate is now in marked decline. It fell to 6.5% in December, down from 7.1% in November, and well below its peak of 9.2% in June. Food prices continue to rise strongly though, up 10.4% y/y in December. Core CPI has been edging lower since peaking at 6.6% in September, declining to 5.7% in December. Core-PCE inflation stood at 4.4% in December, its lowest rate in 2022. It is expected to move back slowly towards the 2% target level in the next couple of years. The latest Fed projections, published at the December meeting, show core-PCE inflation easing to 3.5% by Q4 2023, and to 2.5% in Q4 2024.

The limited amount of available data for January

indicate that activity remained subdued at the start of 2023. The flash readings of both the manufacturing and the services PMI improved, but remained in contraction territory, at 46.6. The manufacturing ISM, though, fell to 47.4. Consumer confidence is somewhat restrained, with the Michigan and Conference Board measures at very low levels. Likewise, the NAHB Homebuilder sentiment index edged higher in January, but stayed at a low level.

To surmise, the US economy grew more slowly than anticipated last year, as inflation surged and monetary policy was tightened significantly. Furthermore, while the headline GDP figures suggest the economy remained in a healthy state in Q4 2022, the underlying details and a slew of other indicators, suggest it lost momentum as the year came to a close. Monetary policy is likely to remain restrictive for an extended period of time which will restrain activity. At the same time, the looming battle over raising the debt ceiling may result in a Government shut-down, which could weigh on GDP further. Overall, the economy looks to be in for a very weak year in 2023. The Fed expects growth to slow to just 0.5% y/y by Q4 2023. This would be consistent with stagnation in activity H1 and weak growth in H2, with GDP rising by around 1% in 2023 as a whole, largely due to carryover effects. The IMF sees GDP growth averaging 1.4% in 2023, which would still imply a weak performance over the course of the year.

