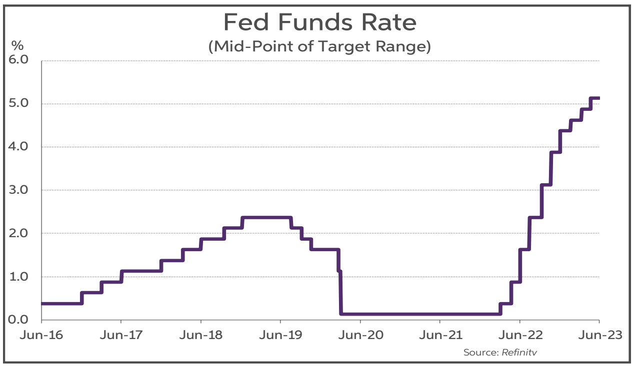
Fed Watch

AIB Treasury Economic Research Unit

15th June 2023

Fed leaves rates unchanged, but a further hike seems likely



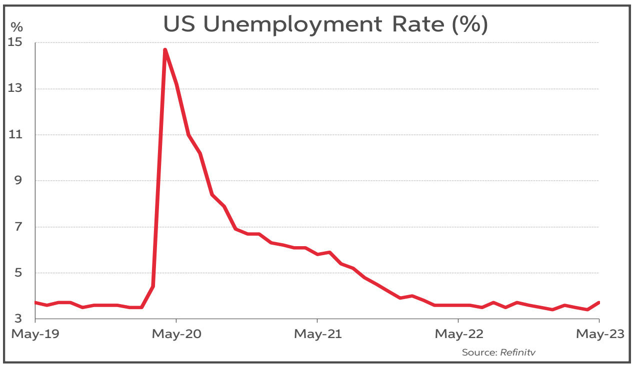
As had been widely expected, the Fed left US rates unchanged at the conclusion of its policy meeting yesterday, maintaining the target range for the funds rate at 5.0-5.25%. The Fed has enacted 500bps worth of rate increases since it commenced tightening policy in March 2022. However, in the run up to this meeting, **several policymakers had signalled they favoured skipping a rate hike on this occasion** to allow the Fed to assess additional information before deciding if any further policy tightening is required. The decision to leave rates unchanged was unanimous.

The market has been of the view recently that the Fed will deliver one final rate hike later this summer, taking the funds rate up to a 5.25-5.50% range. This expectation of further tightening is supported by the Fed's **updated rate projections, or dotplot,** which were published after the meeting. Indeed, this showed that only two of the eighteen FOMC members see no further rate hikes. Four expect one 25bps hike, nine expect two hikes, while three expect three or more rate increases. Thus, the **median Fed projection is for rates to be raised by a further 50bps to a 5.50-5.75% range**. Hence, this was a more hawkish pause in tightening than the market had been expecting.

A key question is, though, if a clear majority of the FOMC believe further rate hikes are necessary, why did they not raise rates yesterday, and then signal a pause until September. It suggests that the Fed's confidence may be low in its projection for 50bps of additional rate tightening. Indeed, the market largely ignored the Fed's projection for the peak in rates and continues to price in that there will be one final 25bps hike in the third quarter, taking the funds rate to a 5.25-5.5% range. In this regard, Fed Chair Powell indicated that July will be a 'live' meeting in terms of a decision to hike rates, in contrast to signalling a pause in the run-up to yesterday's meeting.

The good CPI report for May published this week, which showed another big drop in the annual headline rate to 4% and core inflation beginning to moderate, as well as the downtrend in the annual rate of growth in average earnings increases the chances that rates should not have to rise by more than 25bps from here.

The **latest set of Fed quarterly macro forecasts were also published yesterday.** These show that the economy is proving more resilient and core inflation stickier in 2023 than had been expected back in March. **The projection for the core PCE inflation rate in Q4 2023 was raised from 3.6% to 3.9%,** even further above the 2% target. Crucially, though, the Fed still sees the rate falling to 2.6% by Q4 2024 and 2.2% in Q4 2025. The Q4 2023 unemployment rate forecast was lowered significantly from 4.5% to 4.1%, but again the projections for Q4 2024 and Q4 2025 were little changed at 4.5%.



Meanwhile, in terms of economic activity, **the Fed see GDP growth running at 1.0% y/y in Q4 2023, up from the 0.4% projected in March.** However, here again there was little change in the Q4 2024 and Q4 2025 annual GDP growth forecasts of 1.1% and 1.8%, respectively. Overall, then, growth is seen as remaining subdued in 2023 and 2024, before picking up some momentum in 2025.

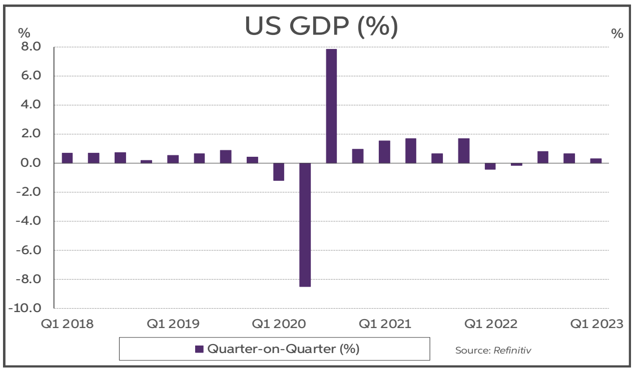
Meantime, **the Fed's view remains that rate cuts will be slow to materialise in the near term, but that significant policy easing is still likely in 2024-25.** The market has been taking this message on board over the past month. It is no longer pricing in rate cuts for later this year, and now sees rates remaining above 5% until end Q1 2024. **The median dotplot 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 current market expectations of rates peaking at 5.375% in Q3 2023. **The market is in agreement, but sees more of the rate cuts occurring in 2024.** It expects rates to fall to 3.875% by the end of next year, implying 150bps in rate cuts in 2024, with a further 50bps of policy easing in 2025, bringing rates down to 3.375%. The latter is right in line with the Fed's projection for rates by Q4 2025.

Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Daniel Noonan
Economist
daniel.x.noonan@aib.ie

Subdued growth expected in US economy for 2023-24



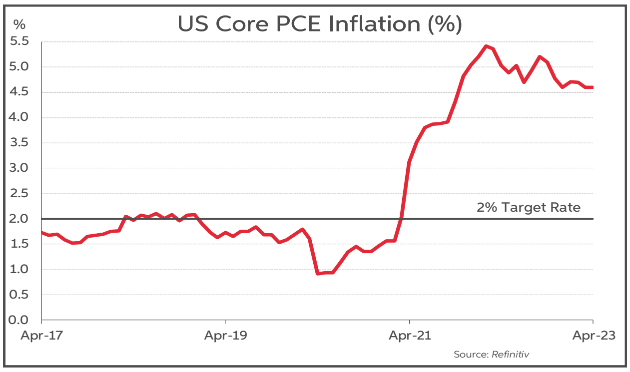
The US economy grew at an annualised rate of 1.3% in Q1 2023, half of the 2.6% growth rate recorded in Q4 2022. However, **the underlying details indicate activity was not as weak as suggested by the headline figure. Indeed, real final domestic sales rose by a strong 3.4% annualised in Q1,** compared to just 0.7% in Q4. Consumer spending continued to grow strongly in Q1, rising by 3.8% in annualised terms. Consumption boosted GDP by 2.5 percentage points (p.p.), although, investment weighed slightly on the total. Meanwhile, Government spending contributed 0.9 p.p. to growth. Net trade was flat, despite a healthy 5% rise in exports. However, inventory destocking knocked a hefty 2.1 p.p from the total.

The survey data so far in Q2, have been mixed. As has been the case for some time now, services are continuing to outperform manufacturing, with the services PMI rising to 54.9 in May, from 53.6 in April. In contrast, the manufacturing index slipped to 48.4 in May, from 50.2 in April. Meanwhile, the non-manufacturing ISM has been in expansion mode for the past three years, bar one month, although, it did fall to 50.3 in May from 51.9 in April. The manufacturing ISM has remained firmly below 50 so far this year, coming in at 47.1 in April and 46.9 in May. Consumer confidence also remains subdued, with the Michigan and Conference Board measures still at weak levels.

Similarly, the available hard data for Q2 have also been mixed. Retail sales rose by 0.3% in May, having rebounded by 0.4% in April, while the control group sales measure, a key indicator of consumer spending, rose by 0.2% and 0.6% in the two months. Meantime, having stagnated in February and March, industrial production increased by 0.5% in April, before declining by 0.2%, in May. Elsewhere, activity in the housing sector has shown further signs of recovery, with building permits, housing starts and existing home sales maintaining upward momentum in April.

In terms of the labour market, conditions remain very tight. Payroll growth has remained robust during the first five months of the year, rising by an average of 314k per month. Meantime, the number of job openings stood at 10.1m in April, up from 9.8m in March, but below the 11.2m figure at the end of 2022. The unemployment rate edged higher to 3.7% in May, having been between 3.4-3.6% for a number of months prior to that. Average earnings growth has been running at 0.3-0.4% per month this year. In year-on-year terms, average earnings stood at 4.3% in May, down from 4.8% in December, and a peak of 5.9% in February 2022.

Regarding inflation, the headline rate is in marked decline. It fell to 4.0% in May, down from 4.9% in April, 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 6.7%. **Core inflation is proving stickier**. Core-CPI declined to 5.7% last December, having peaked at 6.6% in September, but remained in a 5.5-5.6% range in early 2023 until falling to 5.3% in May. Similarly, core-PCE inflation has been in a narrow 4.6-4.7% corridor in the five months to April. 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.



To surmise, the US economy continued to perform well in Q1. 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, recent stresses in the US banking system will 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 OECD sees GDP growing by around 1.5% in 2023, and circa 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% this year, with GDP growth averaging close to 1% in 2024. **The risks to the economy are to the downside,** with fears in particular of a possible marked tightening in credit conditions that would weigh on US activity over the remainder of the year and into 2024.

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit