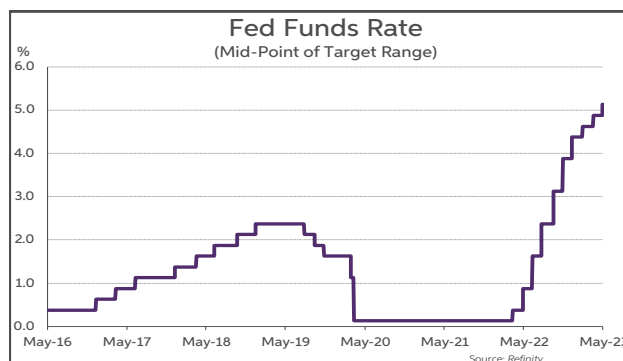


Fed hikes by 25bps, but opens the door to pausing

As widely expected, the Fed announced a further 25bps hike in US rates yesterday. This brings the target range for the Fed funds rate up to 5.0-5.25%. The Fed has now enacted 500bps worth of rate increases since it commenced tightening policy over a year ago. The decision to raise rates by 25bps was unanimous and did not come as a surprise to markets. **It had been well signalled in recent comments by policymakers** and in the projections for interest rates, or dot-plot, that the Fed provided at its last policy meeting in March.

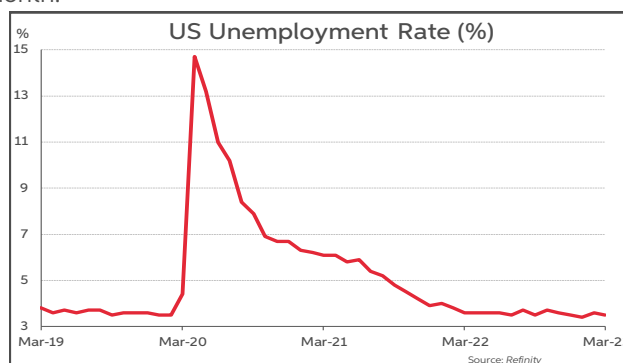


More importantly, as had also been anticipated by markets, the Fed opened the door to pausing its rate tightening cycle. Critically, it dropped the guidance in its previous policy statements that some additional policy firming, “*may be appropriate*”. Instead, it said it would take into account a number of factors in determining the extent to which additional policy tightening may be required. In this regard, the Fed indicated that it would take into consideration the impact of the cumulative tightening to date, including the lagged affects, as well as economic and financial developments in its future policy decisions.

Thus, the Fed is no longer flagging that further hikes are on the cards, but it stopped short of giving a commitment to pause its rate tightening cycle. Chair Powell commented at his post meeting press conference that inflation remains a key concern, and that it is too soon to say with certainty that the rate hiking cycle is over. He did not rule out further rate increases, stating the Fed would be prepared to do more tightening if needed. However, the language of the policy statement suggests that the bar is going to be quite high for further rate hikes to be implemented.

The market is clearly of this view, and is pricing in that rates have now peaked at 5.0-5.25%. There was an expectation earlier in the year that rates could get to a higher level of close to 6%, before the Fed pressed the pause button on tightening. However, the stresses that have emerged in parts of the US banking system this spring are a new headwind for the economy and should help dampen inflation, implying that less monetary tightening would be required. In this regard, **the Fed’s March rate projections showed that most FOMC members expected that policy would be put on hold when rates got to a 5.0-5.25% level.** The view that rates would top out as this level has been reinforced by more recent developments, with fresh signs of stresses in the banking system emerging in the past week, growing concerns about difficulties in securing agreement in Congress on raising the US debt ceiling, as well as a softening in some labour market indicators over the past month.

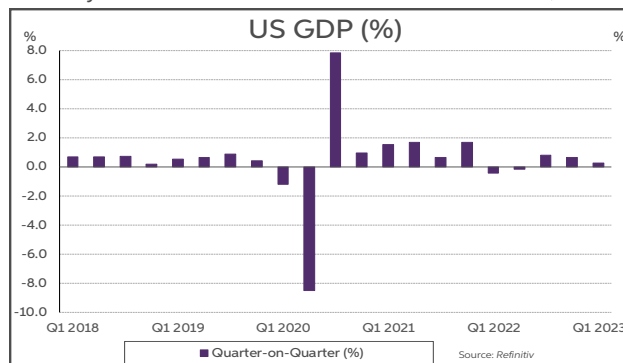
The Fed’s March rate projections also showed that 17 of the 19 FOMC members saw rates above 5% at the end of this year and none were anticipating a rate cut in 2023. This suggests that there is a strong bias to keep policy tight this year. **The Fed indicated once again yesterday that policy easing is not expected to come on the agenda in 2023.** The labour markets remains very strong and even though headline inflation has fallen back since last summer, core inflation is proving sticky and much slower to decline. Chair Powell repeated yesterday that the Fed’s view is that inflation will be slow to come down, and if that proves to be broadly the case, then it would not be appropriate to cut rates this year.



Markets, though, believe that a weakening of the economy as the year progresses is likely to see the Fed starting to ease policy before end 2023. The stresses that have emerged in parts of the US banking system are expected to result in a significant tightening in credit conditions, stifling growth and dampening inflationary pressures. This has added to the belief that the Fed will move to loosen policy before the year is out. **Futures contracts are pricing in rate cuts of 75bps for later this year, with a further 150bps of easing anticipated in 2024 that would take the Fed funds rate down to just below 3%.** The Fed’s view is that rate cuts will be much slower to materialise, with the median dot-plot showing that it expects rate cuts of 100bps in 2024 and again in 2025. This would see the funds rate falling from 5.1% at end 2023 to 4.1% by end 2024 and to 3.1% at end 2025.

Risks to US economic growth continue to rise

The US economy grew at a modest annualised rate of 1.1% in Q1 2023, down from 2.6% in Q4, and 3.2% in Q3 of last year. However, consumer spending continued to grow solidly in Q1, rising by 3.7% in annualised terms. Business investment also continued to expand, but there was yet another fall in residential investment, which contracted by 4.2% annualised. Consumption boosted GDP by 2.5 percentage points (p.p.), although, investment clipped 0.1 p.p. from the total. Meanwhile, Government spending contributed 0.8 p.p. to growth. Net trade added 0.1p.p., led by a healthy rise in exports. However, inventory destocking knocked a hefty 2.7 p.p from the total. Overall then, **the underlying details indicate activity was not as weak as suggested by the headline GDP growth figure**. Indeed, real final domestic sales rose by a strong 3.2% annualised in Q1, compared to just 0.7% in Q4.

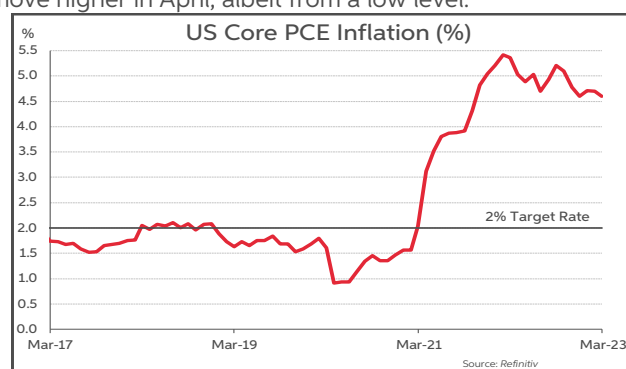


Meanwhile, the labour market remains tight, although, there have been some signs that conditions are starting to soften. The unemployment rate remained relatively steady, between 3.4-3.6% throughout Q1. Furthermore, payroll growth accelerated to an average of 345k in Q1, compared to 284k in Q4. However, as the first quarter of the year progressed, the pace of payroll expansion moderated, from 472k in January, to 236k in March. Meantime, the number of job openings has trended significantly lower so far in 2023, declining to 9.6m in March, from 11.2m at the end of 2022. Weekly jobless claims have also been trending higher recently. Meanwhile, earnings growth has moderated, rising by 0.2-0.3% per month in Q1, compared to 0.4% per month in Q4. In year-on-year terms, average earnings were up 4.2% in March, 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 5.0% in March, down from 6.0% in February, and well below its peak of 9.1% in June. Food inflation remained elevated though, up 8.5% y/y in March. **Core-inflation is also proving to be quite sticky in the US**. Core-CPI edged lower in Q4, declining to 5.7% in December, having peaked at 6.6% in September. In Q1 though, it has been in a 5.5-5.6% range. Similarly, core-PCE inflation has been in a 4.6-4.7% corridor in the four months to March. Overall, the Fed expects inflation to move back only slowly towards the 2% target level over the next couple of years. The latest Fed projections, published in March, are for core-PCE inflation to ease to 3.6% by Q4 this year, 2.6% in Q4 2024, and to 2.1% in Q4 2025.

The limited amount of 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 at 53.6 in April, having moved into expansion territory in February. The manufacturing index has been trending higher recently, and rose to 50.2 in April, consistent with a stabilisation of activity in the sector. Meanwhile, the non-manufacturing ISM edged higher to 51.9 in April from 51.2, while the manufacturing ISM improved, but remained firmly below 50, at 47.1. Consumer confidence remains restrained, with the Michigan and Conference Board measures still at weak levels. The NAHB Homebuilder sentiment index, though, has continued to move higher in April, albeit from a low level.

To surmise, the US economy continued to perform well in Q1. More recently, data have been mixed, with signs emerging that labour market conditions are 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, the most recent NFIB small business survey indicates that firms were already starting to experience tighter credit conditions in March. At the same time, the looming battle over raising the debt ceiling has intensified, and may result in a Government shut-down, which would also weigh on GDP. Overall, the US economy is set to grow more slowly this year, have expanded by 2.1% in 2022. **Both the IMF and OECD see GDP growing by around 1.5% in 2023, and circa 1% in 2024**. Meanwhile the Fed expects growth to slow to 0.4% y/y by Q4 2023, pointing to an average growth rate above 1% this year. Overall, **the risks to the economy are to the downside** and are growing amid fears of a marked tightening in credit conditions in the US as the year progresses.



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