US Watch

July FOMC quick reaction: Back in the saddle with maximum optionality

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Key takeaways

- The Fed lifted its target range for the federal funds rate by 25bp to 5.25-5.50%, which was widely expected.
- Chair Powell signaled the desire to retain maximum optionality about what to do on a meeting-by-meeting basis.
- We retain our view for one more 25bp rate hike at the September FOMC meeting for a terminal target range of 5.50-5.75%.

The decision: back in the saddle again

The Fed lifted its target range for the federal funds rate by 25bp to 5.25-5.50%, which was widely expected. Powell said that the committee remains strongly committed to the 2% goal. He mentioned that inflation has "moderated somewhat" since the middle of last year but has a "long way to go" and reiterated the data-dependent approach on further hikes. Powell's statements today were in line with our view that the Fed would justify action this meeting on account of the totality of the data since it last raised the policy rate in May, including growth in activity, strong demand for labor, and diminished stresses on regional banks.

Changes in the FOMC statement were in line with our expectations. In addition to raising the funds rate by 25bp, the FOMC statement retained the existing policy rate guidance: "In determining the extent to which additional policy firming may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." In addition, the statement continues to indicate an emphasis on data dependence, saying "The Committee will continue to assess additional information and its implications for monetary policy."

Market reaction

The rates market interpreted the July FOMC as slightly dovish, as rates declined as much as 8bps during the press conference. The FOMC statement was in line with expectations, and the market heard balanced comments from Fed Chair Powell. The market likely expected a slightly more hawkish tone from Chair Powell that pushed back on rate cuts in early 2024 and the recent easing of financial conditions. The lack of hawkish basis and Chair Powell's data-dependent and balanced assessment seemingly supported the rate decline.

Going into the meeting, we saw limited scope for a material USD move, as the policy decision was fully priced, and guidance would most likely lean towards optionality/flexibility and ongoing data dependence, with perhaps a slight hawkish bias. For the most part, the overall policy communication appeared neutral.

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US Economics

The decision: back in the saddle again

In terms of the policy rate decision, the Fed lifted its target range for the federal funds rate by 25bp to 5.25-5.50%, which was widely expected. Powell said that the committee remains strongly committed to the 2% goal. He mentioned that inflation has "moderated somewhat" since the middle of last year but has a "long way to go" and reiterated the data-dependent approach on further hikes. Powell's statements today were in line with our view that the Fed would justify action this meeting on account of the totality of the data since it last raised the policy rate in May, including growth in activity, strong demand for labor, and diminished stresses in regional banks.

In fact, there was very little commentary on risks to the outlook from banking sector stress despite the decision to retain the language in the FOMC statement that the extent of tighter credit conditions "remains uncertain." In response to a question on bank stress and proposed mergers, Powell said: "I don't want to comment on any particular merger proposal, but I will say things have settled down for sure out there. Deposit flows have stabilized. Capital and liquidity remain strong. Aggregate bank lending was stable quarter over quarter and up significantly year over year. Banking sector profits are coming in strong this quarter. Overall, the banking system remains strong and resilient." He suggested that these developments made it easier to conclude to raise the policy rate in July after not having done so in June.

July statement: upside bias to the policy path remains

Changes in the FOMC statement were in line with our expectations. In addition to raising the funds rate by 25bp, the FOMC statement retained the existing policy rate guidance: "In determining the extent to which additional policy firming may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." In addition, the statement continues to indicate an emphasis on data dependence, saying "The Committee will continue to assess additional information and its implications for monetary policy."

In the opening paragraph, where the Fed describes the incoming data, the description that "job gains have been robust in recent months" was unchanged, and the Fed still sees inflation as "elevated," despite the June inflation data.

An upgrade to the description of growth in economic activity

In a minor surprise to us, the Fed adjusted its description of growth in economic activity, saying that the economy "has been expanding at a moderate pace," which we interpret as stronger than the "modest pace" description used in June. We think that this upgrade reflects the upward revisions to 1Q data, which put growth in real GDP at 2.0% q/q saar (seasonally adjusted annual rate), about 1pp higher than the advance estimate initially reported. In addition, it also likely reflects incoming data that we think will leave GDP growth near trend at 1.5% q/q saar in the advance estimate of 2Q US GDP this week. The upgrade to the description of activity fits our view that the Fed sees the domestic economy on fairly solid footing and supports our outlook for another rate hike before the terminal rate is reached.

Press conference: retain optionality

By our ear, Powell continues to emphasize four main messages. First, the committee will do what is necessary to return inflation to 2% over time. Second, in bringing inflation down, the committee would prefer to avoid imposing undue harm to the economy. Slowing the pace of policy rate actions allows for fine-tuning of the policy stance. Third, appropriate forward guidance includes the potential for more policy rate hikes. Finally, Powell clearly wants to retain maximum optionality about what to do on a meeting-by-meeting basis. He does not want to be boxed in one way or another.

Monetary policy outlook: we expect the last rate hike in September

We retain our view that the Fed has one more policy rate hike in store and look for a 25bp rate hike at the September FOMC meeting for a terminal target range of 5.50-5.75%. Furthermore, we retain our view that the first policy rate cut will come in May 2024.

News on the balance sheet: cutting rates while QT continues

Our current baseline outlook for monetary policy also includes an end to quantitative tightening (QT) when rate cuts begin, but for the first time, Chair Powell actively suggested that the Fed could consider letting securities roll off its balance sheet while reducing its policy rate. In response to a question about whether the Fed is considering such an outcome, Powell said, "That could happen. The question is, is that consistent with…if you think about them both as normalization. Imagine it's a world where things are okay and it's time to bring rates down from our restrictive levels to more normal levels. Normalization in the case of the balance sheet would be to reduce QT. Or to continue it depending on where you are in the cycle. There are two independent things. The active tool of monetary policy is rates. But you can imagine circumstances in which it would be appropriate to have them working in what might be seen to be different ways but that wouldn't be the case."

We think, ultimately, that whether the Fed decides to let the balance sheet continue to run off as it cuts rates depends on economic outcomes. The more the economy "soft lands," the more likely it will be that the Fed extends quantitative tightening longer. If the economy experiences a downturn, similar to the mild recession in our outlook in 1H 2024, then we think that the Fed would be inclined to end QT and have its tools working more in concert.

US Rates

The rates market interpreted the July FOMC as slightly dovish as rates declined as much as 8bps during Chair Powell's press conference. The FOMC statement was in line with expectations, and the market heard balanced comments from Fed Chair Powell. Chair Powell reiterated a data-dependent stance, highlighted a balanced assessment of risks to the outlook, and highlighted evidence of a tightening in credit conditions (we note that "balance" in the press conference was mentioned 13x in July, 9x in June, and 7x in May). The market likely expected a slightly more hawkish tone from Chair Powell that pushed back on rate cuts in early 2024 and the recent easing of financial conditions. The lack of hawkish basis and Chair Powell's data-dependent and balanced assessment seemingly supported the rate decline.

The rate decline was most concentrated in intermediate tenors and real rates. Specifically, the 3- to 5-year part of the nominal and real rate curves led the move. The composition of this rate decline is consistent with a lower trough of rate cuts achieved in 2025. Breakeven rates of inflation were little changed. The composition of the rate decline is consistent with a more data-dependent and balanced assessment that implies rate cuts over the course of 2024 and 2025.

Overall, the July FOMC does not materially change our view on rates. We continue to believe that clients should fade the extent of rate cuts in early 2024; a Dec '23 – Mar '24 steepener is our preferred expression. We also continue to recommend that clients remain neutral to slightly long their duration benchmarks given slowly moderating economic growth and inflation. We recommend that clients go long the 10-year US Treasury (UST) at levels above 4% and lighten up as rates drop towards our year-end 10-year forecast of 3.5%.

The operational details of the Fed decision were in line with expectations: IOR = 5.4%, overnight reverse repo (ON RRP) = 5.3%, ON RRP program terms were unchanged. On QT, Chair Powell noted that it was possible that the Fed could continue reducing its balance sheet if cutting rates. This suggests the possibility of larger UST financing needs, which would likely justify a larger set of coupon supply increases in 2H 2023 and early 2024. We continue to believe that the set of the conditions in which the Fed cuts rates will matter for the QT outlook: if cutting to offset a recession, it seems likely that the Fed would pause QT; if cutting with slowing inflation and a resilient economy, QT could continue.

FX

Going into the meeting, we saw limited scope for a material USD move, as the policy decision was fully priced, and guidance would most likely lean towards optionality/flexibility and ongoing data dependence, with perhaps a slight hawkish bias. For the most part, the overall policy communication appeared neutral: the statement was little changed, and the net result from the press conference seemed to emphasize a meeting-by-meeting approach.

The dollar was slightly lower on net, depreciating between 0.2 and 0.4% versus G10 currencies, consistent with the slight move lower in rates (as noted above). The moves likely reflected some short-term positioning rather than any materially new assertive policy signals, as the market may have been positioned for more hawkishness at the margin. Upcoming key economic data and possibly headlines from Jackson Hole will likely be more influential for the dollar going into the September FOMC.

Despite the USD's notable selloff earlier this month, we remain constructive in the short term, as broader economic resilience suggests that eventual rate cuts would likely occur later than currently priced, all else equal. While we still see the dollar overvalued for the longer term, the fight against inflation in relatively a resilient economy should have USD supportive aspects.

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