Liquid Insight

FOMC preview: The end of the road

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Global

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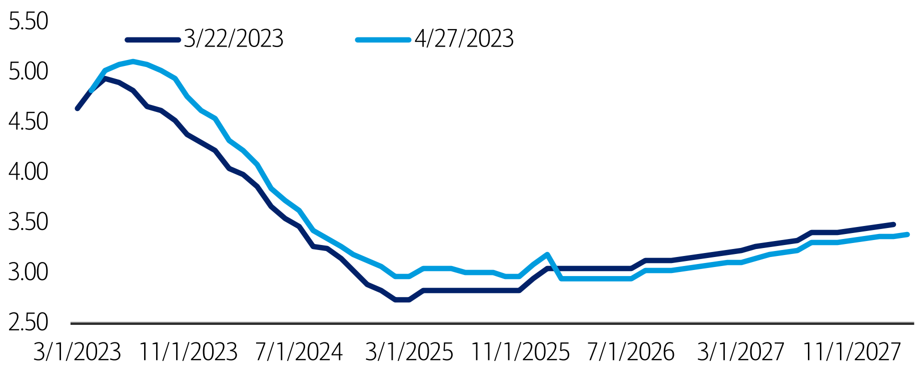
Key takeaways

- We expect another 25bp rate hike for a target funds rate of 5.0-5.25%, likely being the last hike of the cycle.
- A hike in June cannot be ruled out at this stage. The Fed is likely to retain some upward bias in its policy rate guidance.
- If Fed communications are in line with our expectations, it will likely result in limited rates price response.

By: Michael Gapen, Mark Cabana & Alex Cohen

Exhibit 1: Fed fund futures curve (%)

Rates market pricing suggests the May hike will be the last of the cycle



Source: Bloomberg

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One last 25bp hike

In our view, the Fed will increase the target range for the federal funds rate by 25bp to 5.0-5.25% at the May meeting and conclude its current tightening cycle. We expect the committee to send the message that it believes monetary polic is in the vicinity of being sufficiently restrictive, but further policy rate hikes cannot be fully ruled out.

Rates market pricing suggests that the May hike will be the last of the cycle. BofA Global Research agrees. Further hikes are possible but face a higher hurdle given cracks in the banking system. At present, the market prices only 6bps of hike at the June FOMC meeting. We think 5-7bps of hike in June seems fair with current data. This week's FOMC is shaping up to be potentially less eventful for the dollar than the March meeting, as the range of likely outcomes has narrowed with the easing of acute financial stability risks.

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US economics: One and (likely) done

In our view, the Fed will increase the target range for the federal funds rate by 25bp to 5.0-5.25% at the May meeting and conclude its current tightening cycle. This outcome would align with our assessment of the US outlook, but, more importantly, it appears consistent with the Fed's communication since the conclusion of the March FOMC meeting. We expect no change in the Fed's balance sheet policies.

The macro data has been mixed, but largely favorable, with gowth in public and private consumption underpinning solid growth in domestic demand in 1Q. That said, residential and equipment investment declined further, and momentum ebbed as the quarter wore on. With the three-month average increase of private payrolls at 269k and core PCE inflation at 4.6% yoy in March, we think the Fed will be inclined to act.

However, there is enough uncertainty in the outlook to raise the bar for further hikes. The decline in Fed emergency lending has mainly come from FIMA repo lending, which goes to foreign official institutions, and not from domestic sources. While emergency lending has fallen by US$63.5bn over the past four weeks, loans (discount window lending, Bank Term Funding Program, and other credit extensions) have fallen by only US$8.5bn. Loans over the past two weeks have risen. Bank stress may not be getting worse, but it is hard to conclude that it is getting better quickly.

In addition, bank loan growth is slowing. The 13-week annualized growth rate in the nominal value of loans and leases in bank credit is up 3.5% through 12 April, with C&I lending down 5.2%. Much of the contraction in lending in this category comes from small banks, where C&I loan growth is down 10% against only 2.6% at large banks. The next Senior Loan Officer Opinion Survey, which the Fed will have on hand before the May meeting, is likely to show that standards and terms have been tightened further.

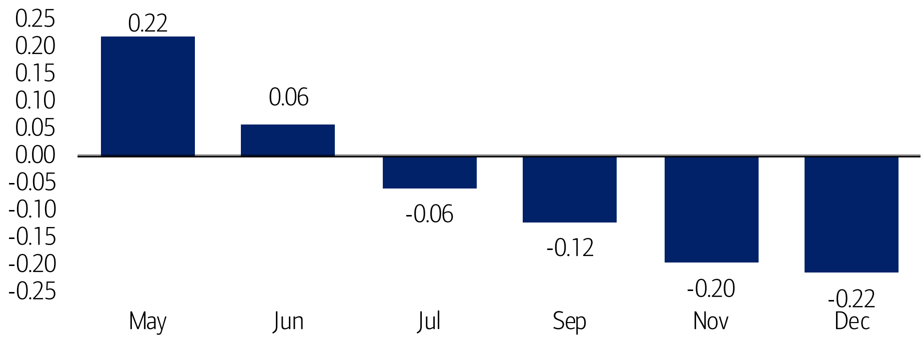
We expect the committee to send the message that it believes monetary policy is in the vicinity of being sufficiently restrictive, but further policy rate hikes cannot be fully ruled out. In our view, the FOMC statement is likely to say, "some additional policy firming may yet be appropriate." This would send the signal that the committee will keep its options open after the May meeting should incoming data suggest further tightening is required. A hike in June cannot be ruled out given that the Fed will see two employment reports and another inflation report between the May and June FOMC meetings.

For our full FOMC preview, see the report May FOMC Preview: One and (likely) done.

US rates: Cautious hike expected

The Fed is expected to deliver its last 25bps hike of this cycle at the May FOMC meeting. Recent resurgence of bank stress is unlikely to de-rail the Fed given that concerns are concentrated in a single name or a few names. Widespread bank stress would likely be required to de-rail the 25bp hike in May.

Exhibit 2: Incremental hikes/ cuts priced in from FOMC OIS (ppts)
FOMC-OIS shows almost a full 25bp cut by YE'23



Source: Bloomberg

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Rates market pricing suggests the May hike will be the last of the cycle (Exhibit 1). BofA research agrees. Further hikes are possible but face a higher hurdle given cracks in the banking system. At present, the market prices only 6bps of hikes at the June FOMC meeting (Exhibit 2). We think 5-7bps of hike in June seem fair given the current data.

The rates market is likely to hear a Fed that is more cautious. Fed is still data dependent but onus is now on data to disprove the hold. If inter-meeting data is 50/50 hike vs. hold, the tie now goes to the hold. Even if data is 60/40 hike vs. hold, the Fed will likely hold. If data is 80/20, then hike. Again, onus is on data to disprove the hold.

Fed communication, in line with our expectations above, will likely result in limited rates price response. Rates market will be more focused on bank stress, next Friday's payroll data, & debt limit dynamics. An adverse debt limit outcome risks earlier Fed cuts. Risks around the meeting likely skew in the direction of higher rates or a more hawkish sounding Fed, given market pricing for hold & future cuts.

We expect no change in administered rate setting within the target range at the May FOMC. The market continues to speculate on the possibility of a reduction in the Fed ON RRP rate or maximum cap. We believe any ON RRP rate or cap reduction is unwarranted & unnecessary given current money market dynamics. It has also not been seriously discussed by Fed officials.

We continue to believe it is more likely that the ON RRP per counterparty cap is raised and not lowered. This is especially true with debt limit concerns. Any contentious debt limit standoff will likely see MMF investments that favor Fed ON RRP vs. potentially delayed payment for USTs. We expect the Fed to act in support of market functioning around any debt limit stress, including potentially increasing the ON RRP cap.

FX: Rangebound USD looking for guidance

This week's FOMC is shaping up to be potentially less eventful for the dollar than the March meeting, as the range of likely outcomes has narrowed with the easing of acute financial stability risks. Given ~90% probability that markets are prepared for a 25bp hike, dollar will most likely take any cues from the forward guidance in the statement and press conference.

Any statement language that clearly points to a bias for another hike in June should spark a reactive dollar rally, given current market pricing (~+5bps for June) and a seeming consensus on a bearish dollar sentiment among investors. This could also be the case should Chair Powell emphasize on a notion that more work will be needed to bring inflation back to target, beyond reiterating projections that rates will be held at terminal for an extended period. As market pricing and Fed projections have been at odds for some time now, something more assertive here would likely be needed to move the needle.

On the other hand, clear expressions of caution should reaccelerate the dollar's recent downtrend, as focus would shift to the length of the hold, and timing of subsequent cuts. This could include strong references to the anticipated effects of credit tightening, still elevated uncertainty related to financial stability risks, or signs that activity is cooling.

Nevertheless, should communication unfold in line with our expectations, the net USD reaction would be limited. The outlook should become a bit clearer going into the June FOMC, given that the in-between period will contain two employment reports and two CPI releases, which could provide the early signals of the degree of impact that credit tightening is starting to have on the economy. As the Fed is still data dependent, this should ultimately be more relevant for the dollar than parsing words in the May statement. Thursday's ECB meeting will likely be more impactful, where market pricing currently stands between a 25 and 50bp hike.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- A year of many narratives, **Global FX Weekly**, 28 Apr 2023
- Are we there yet**, Global Rates Weekly**, 28 Apr 2023
- EURUSD & NZD selling, mixed JPY & NOK, **Liquid Cross Border Flows**, 24 Apr 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: A year of many narratives 28 April 2023

Global Rates Weekly: Are we there yet? 28 April 2023

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