BofA SECURITIES

Liquid Insight

June FOMC Meeting: Skip to assess lags

12 June 2023

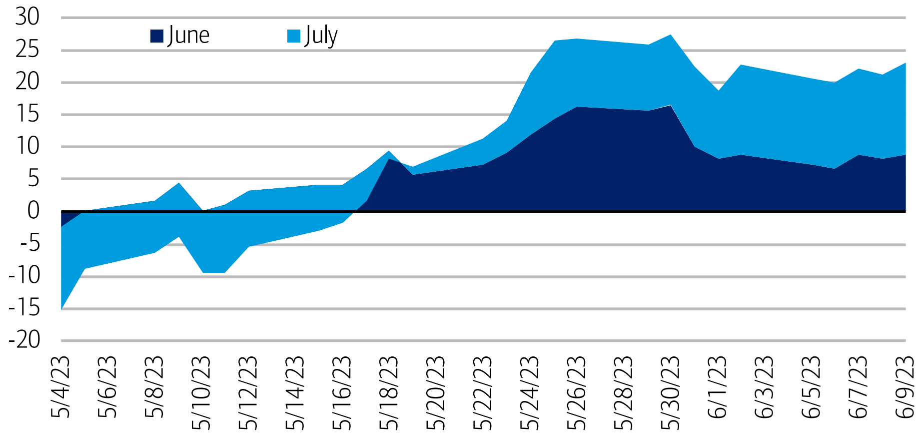
Rates and Currencies Research
Global

Key takeaways

- We expect the Fed to maintain the target range for the fed funds rate at 5.0-5.25%, though believe it to be a close call.
- The Fed likely wants time to assess policy lags and regional bank stress, but guidance should point to an upward rate bias.
- The June FOMC is unlikely to materially impact pricing for July but could assist in reducing the extent of cuts in '24.

By Michael Gapen, Mark Cabana, & Alex Cohen

Chart of the Day: Total hikes priced by FOMC meeting since May (bps)
The market is pricing nearly 1 full 25bp hike by July



Source: BofA Global Research; Bloomberg

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A Skip is not a pause

In our view, the Fed will maintain the target range for the federal funds rate at 5.0-5.25% at the June FOMC meeting, though we believe this to be a close call. While incoming data point to resilience in activity and stickiness in inflation, the Fed appears to want additional time to monitor policy lags and regional bank stress.

The June FOMC meeting is unlikely to materially impact pricing for July but could assist in reducing the extent of cuts in '24. The median '23 dot will likely shift higher 25bps, consistent with the risk of a potential hike at an upcoming meeting & leaving July pricing around 15-20bps. Pricing of cuts in '24 is more at risk; FFZ3-FFZ4 has barely moved despite pricing out of cuts in '23. A more careful Fed today lowers risks of hawkish policy mistake; higher for longer outcomes & near-term bear flattening risks could rise.

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ECON: A skip is not a pause

In our view, the Fed will maintain the target range for the federal funds rate at 5.0-5.25% at the June FOMC meeting, though we believe this to be a close call. While incoming data point to resilience in activity and stickiness in inflation, the Fed appears to want additional time to monitor policy lags and regional bank stress. Market pricing is in the Fed's favor, with a full hike not priced until the July meeting.

However, we do not believe the Fed is close to signaling a prolonged pause. Instead, we expect the Fed to say that inaction in June is more akin to a skip – for now – and the committee retains upward bias to its policy rate path. This will likely be reflected in the FOMC statement, which should maintain language about the potential for additional policy rate firming, the Chair's message at the press conference and the updated set of economic projections, where we expect upward revisions to growth and inflation, a lower unemployment rate path, and a higher median policy rate. We expect the median dot in 2023 and 2024 to rise by 25bp and 37.5bp, respectively, to 5.25-5.5% and 4.5-4.75%. (Exhibit 2)

We think Chair Powell will have several hurdles to overcome during the press conference. Chair Powell will have to explain why the committee needs time to assess policy lags and bank stress, while the median member sees enough in the data to justify guiding markets to another hike in July. In our view, moving the median 2023 dot higher helps in two ways. First, it could help prevent an undesired easing in financial conditions following a decision to hold. In addition, it will help Powell leave the door open to further hikes, emphasizing the decision to skip and not pause. We think it will be difficult to execute this without some easing in financial conditions, but slippage in market pricing for July could be minimal.

Exhibit 2: BofA Global Research expectations for the June Summary of Economic Projections (SEP)

We expect the June SEP to show a stronger economy, higher inflation and higher policy rates in 2023

	2023	2024	2025	Longer Run
Change in real GDP (% 4Q/4Q)				
June SEP (BofA expectations)	0.7	1.1	1.8	1.8
March SEP	0.4	1.2	1.9	1.8
Unemployment rate (%)				
June SEP (BofA expectations)	4.2	4.6	4.6	4.0
March SEP	4.5	4.6	4.6	4.0
PCE inflation (% 4Q/4Q)				
June SEP (BofA expectations)	3.3	2.5	2.1	2.0
March SEP	3.3	2.5	2.1	2.0
Core PCE inflation (% 4Q/4Q)				
June SEP (BofA expectations)	3.8	2.7	2.1	
March SEP	3.6	2.6	2.1	
Federal funds target rate (midpoint)				
June SEP (BofA expectations)	5.4	4.6	3.1	2.5
March SEP	5.1	4.3	3.1	2.5

Source: BofA Global Research; Federal Reserve Board

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US rates: hawkish holds are hard

The Fed seems to be aiming for a difficult-to-orchestrate hawkish hold. A hawkish hold seems difficult because actions speak louder than words. If truly hawkish, why not hike? Macro data has been resilient & inflation is too high. Concerns over bank stress likely factor heavily into their thinking. The Fed should also be aware of the UST bill supply surge & knock-on upward pressure for money markets.

The June FOMC meeting is unlikely to materially impact near-term pricing for July but could assist in reducing the extent of cuts in '24. The median dot in '23 will likely shift higher 25bps, consistent with the risk of a potential hike at an upcoming meeting & leaving July pricing around 15-20bps (Exhibit 3). Market pricing of cuts in '24 is more at risk; FFZ3-FFZ4 has barely moved despite material pricing out of cuts in '23 (Exhibit 4).

A more careful Fed today lowers risks of hawkish policy mistake; higher for longer outcomes & near-term bear flattening risks could rise.

Recent surprises from the BoC & RBA remind that a June rate hike can't be ruled out. Historically, the Fed hasn't surprised with hikes; our prior analysis suggests "the Fed has typically raised rates only when fed funds futures were pricing at least 80% odds of such an action the day before a meeting" (see Does the Fed surprise with hikes?). A hot CPI will be required to consider a surprise.

Finally, we expect no changes in Fed administered rate setting, including ON RRP rate or per counterparty caps. We remain highly convicted that ON RRP use will fall organically with upcoming UST bill supply & without the Fed acting to "push" cash out. ON RRP hasn't moved much with bill supply post debt limit; we expect that it eventually will (see Bill surge: strong demand thus far).

Exhibit 2: Total hikes priced by FOMC meeting since May (bps)
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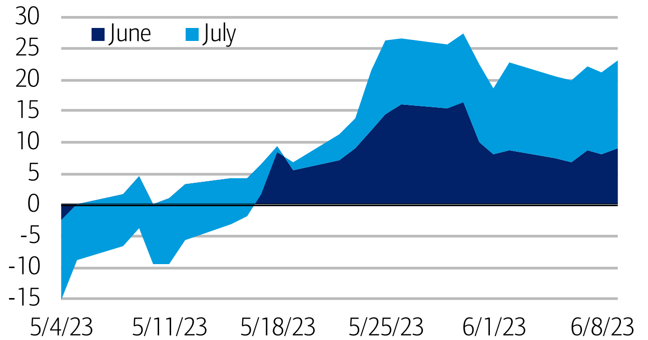

Source: Bloomberg

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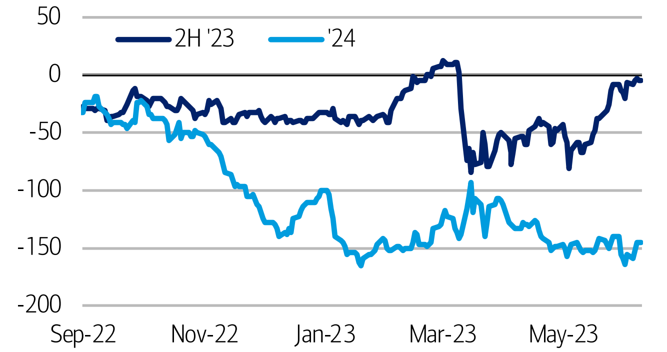
Exhibit 3: Rate hikes or cuts in 2H '23 & '24 (bps)
Fed cuts in 2H '23 have been removed while cuts in '24 are little changed



Source: Bloomberg

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FX: Potential USD softness could be short lived

The latest USD uptrend from mid-May was primarily driven by resilient US data (in contrast to softening data abroad), and commentary by some Fed officials expressing a preference for a terminal rate higher than the current 5-5.25% range. Towards the end of the month, however, a more balanced view expressed by Chair Powell, and a specific reference to a "skip" by Governor (and Vice Chair nominee) Jefferson served to arrest the USD's recent ascent. Market pricing for a June hike shifted quickly from ~75% to the current ~25-30%, bringing the Bloomberg Dollar Index about 1.25% off its recent peak.

With the market narrative focused on the likely "skip", how the Fed guides and eventually delivers on expectations for the fed funds path (both at this meeting and beyond) will be relevant to the dollar's outlook over the summer. However, overly strong signals may not emerge at this FOMC, given the expected policy deceleration and ongoing data dependence.

Barring a material upside surprise in Tuesday's CPI report, the broad (but not universal) market consensus is for an unchanged fed funds rate with some statement language reiterating that more hikes could be in store. But the mere fact that a further 25 bps in July would not be guaranteed (in contrast to a hypothetical June hike) could open the door for a more "dovish" interpretation of this scenario. All else equal, the FX market could see a slightly higher hurdle to justify future hikes after a "skip" signal has been delivered, leaving the onus on the incoming data and/or subsequent Fed communication to reinforce expectations of a higher terminal rate.

As such, there could be limited scope for the dollar to rally significantly on back of this Fed meeting, barring a surprise hike. That said, we would look for any immediate dollar softness on a "dovish" interpretation to be short lived. We still see scope for USD support this year driven by a tight labor market and sticky inflation. A July hike would still be highly probable, and cuts in 2023 seem much less so. Further out, we see the dollar softening on a return towards equilibrium, but that is increasingly looking like 2024 story.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- High(er) rates for (much) longer **Global FX Weekly**, 09 June 2023
- Commonwealth Surprise **Global Rates Weekly**, 09 June 2023
- USD breather, **Liquid Cross Border Flows**, 05 June 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: High(er) rates for (much) longer 09 June 2023

Global Rates Weekly: Commonwealth Surprise 09 June 2023

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