Federal Reserve Watch

May FOMC: Fed pause, but no Fed pivot

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A May hike: Data in hand outweighs uncertainty

As expected, the Federal Reserve raised the target range for the federal funds rate by 25bp to 5.0-5.25%. Although we think the Fed is clearly concerned about ongoing stresses emanating from regional banks, data in hand outweighed uncertainty about the effects of tighter credit conditions when it came to deciding on another rate increase.

Likely on hold; weak upside bias to the policy rate path

When asked about whether the Fed is prepared to pause interest rate increases, Chair Powell said that "a decision to pause was not made today" and kept the door open to additional policy rate hikes should they be needed. Though he said monetary policy was tight and "we may not be far off" from being sufficiently restrictive, Powell said the Fed needs to see more data before it can definitively declare the hiking cycle as over. Should regional bank stress stabilize, labor markets stay tight, and inflation stay elevated, a rate hike in June could move into the baseline.

Transitioning from "higher for longer" to "longer"

Even though the lagged effects of monetary policy appear to be showing up in in activity, Powell emphasized that there is "a long way to go" in terms of meeting the Fed's goals. On inflation, he said that inflation pressures have moderated, but emphasized that "inflationary pressures continue to run high" and "it will take time" to restore price stability. In our view, this messaging suggests the Fed is transitioning its communication from "higher for longer" to "longer". The Fed may be pausing, but it does not see itself as close to a pivot.

The effect of bank stress remains uncertain

As was the case in March, the Fed believes it knows enough to say that bank stress will lead to tighter credit conditions, but it is not yet ready to conclude by how much and the extent to which it weighs on economic activity, hiring, and inflation. Powell said, "it is impossible to have a precise estimate" of any equivalence between bank stresses, credit tightening, and policy rate increases, though he acknowledged that it "complicates the task of achieving a restrictive stance.

Our policy outlook remains unchanged

We continue to forecast the US economy to enter a mild recession beginning in 3Q 23, and for inflation to return to the Fed's 2% target by the end of next year. One of our core views is that returning inflation to the Fed's target requires the removal of labor market imbalances and a modestly larger backup in the unemployment rate than the Fed currently projects (our forecast has a peak-to-trough decline in real GDP of about 1% and a peak unemployment rate of 4.7% in 1Q 24). We think this would open the door for rate cuts – and an end to QT – beginning in March of next year.

A May hike: Data in hand outweighs uncertainty

As expected, the Federal Reserve raised the target range for the federal funds rate by 25bp to 5.0-5.25%. The decision did not come as a surprise to us given incoming economic data, which has generally remained healthy. We think the Fed is clearly concerned about ongoing stresses emanating from regional banks that could reduce credit availability and lead to downside risk to the outlook. However, as noted in the FOMC statement, the extent of tighter credit conditions "remains uncertain", but "the committee remains highly attentive to inflation risks." Inflation remains too high for the Fed's liking and inconsistent with price stability. In other words, inflation still dominates and actual data in hand – and what it implies about how long it may take to restore price stability – outweighed uncertainty from bank stress when it came to deciding on whether another rate increase was appropriate.

Likely on hold; weak upside bias to the policy rate path

In terms of forward guidance, the FOMC statement now reads that, "[i]n 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." Although we anticipated the language could be a bit softer – we suggested "may yet be appropriate" in our FOMC preview (see May FOMC preview: One and (likely) done, 30 April 2023) – we view the guidance as largely in line with our expectation. The goal, in our view, was to communicate the Fed has likely finished the hiking cycle, but more tightening cannot be ruled out. We think the new language accomplishes this goal.

When asked about whether the updated statement indicates the Fed is prepared to pause interest rate increases, Chair Powell said that "a decision to pause was not made today" and kept the door open to additional policy rate hikes should they be needed. He viewed the language changes around forward guidance as "meaningful". He said the committee will take up the question in June based on incoming data.

When asked whether the current policy stance was "sufficiently restrictive", Powell said that this "is an ongoing assessment…we are going to need data to accumulate…it is not possible to say that now." He balanced this by saying that he felt monetary policy was tight and the extent of policy rate hikes put into place, quantitative tightening, and credit tightening likely means "we may not be far off" from being sufficiently restrictive. Finally, he pointed to the median participant in the March Summary of Economic Projections and the expectation that 5.0-5.25% would likely be the appropriate terminal rate. The Fed's assessment of the policy rate stance will be revisited in June.

In our view, we think the Fed has indeed reached its terminal target range and do not forecast additional hikes. That said, there is upside bias in forward guidance. There are two employment and inflation reports before the June FOMC meeting (the second CPI report arrives during the June FOMC meeting). Should regional bank stress stabilize, labor markets stay tight, and inflation stay elevated, a rate hike in June could move into the baseline. The bar for action is higher: the doves likely had to argue against rate hikes in May, but we think the hawks will have to argue for rate hikes in June.

Transitioning from "higher for longer" to "longer"

In terms of assessing incoming data and its implications for the outlook for monetary policy and the economy, Chair Powell noted that growth in economic activity had "slowed significantly" with real GDP up at a below-trend 0.9% pace last year and up only 1.1% q/q saar in 1Q 23. He characterized housing as "weak" and saw higher interest rates and moderating demand as "weighing on" business fixed investment.

However, even though the lagged effects of monetary policy appear to be showing up in in activity, Powell emphasized that there is "a long way to go" in terms of meeting the Fed's goals. Although some indicators show that labor supply and labor demand are "coming into better balance," Powell said, "labor demand still substantially exceeds supply of available workers." On inflation, he said that inflation pressures have moderated, but emphasized that "inflationary pressures continue to run high." He then went on to emphasize that "it will take time" to restore price stability.

In our view, and assuming that the hiking cycle is complete, this messaging suggests the Fed is transitioning its communication from "higher for longer" to "longer". In other words, if the tightening cycle was originally about three components – how fast, how high, and how long – then the Fed sees itself as having answered the first two parts. The remainder – how long policy rates are expected to remain at the terminal range before transitioning to rate cuts – is unknown and dependent on the evolution of inflation. To some extent, the Fed is trying to push back against the notion of a quick pivot to rate cuts until the committee has confidence that inflation is on a path to 2% outcomes. The Fed may be pausing, but it clearly does not want markets to think it is close to a pivot.

When asked directly about the reaction function and the outlook for policy rate cuts, Powell's answer focused solely on inflation. He said, "we, on the committee, have a view that inflation is not going to come down quickly…it will take some time…and, in that world, it would not be appropriate to cut rates [this year]." Powell went on to say that an alternative forecast could lead to alternative policy rate paths and earlier cuts, but "that's not our forecast…the history of the last two years has been very much that inflation moves down [slowly]". To bring inflation down, he said, "we think demand will have to weaken a little bit and labor market conditions will have to soften a bit more to begin to see progress. In that world, it wouldn't be appropriate for us to cut rates."

We continue to forecast the US economy to enter a mild recession beginning in 3Q 23, and for inflation to return to the Fed's 2% target by the end of next year. One of our core views is that returning inflation to the Fed's target would require a removal of labor market imbalances and a modestly larger backup in the unemployment rate than the Fed currently projects (our forecast has a peak-to-trough decline in real GDP of about 1% and a peak unemployment rate of 4.7% in 1Q 24). We think this would open the door for rate cuts – and an end to QT – beginning in March of next year.

The effect of bank stress "remains uncertain"

As was the case in March, the Fed believes it knows enough to say that bank stress will lead to tighter credit conditions. That said, the Fed is not yet ready to conclude by how much and the extent to which it weighs on economic activity, hiring, and inflation. Instead, the Fed continues to state that its assessment of the economy and the proper stance of policy will include both "economic and financial developments". He reiterated his view from March that "it is impossible to have a precise estimate" of any equivalence between bank stresses, credit tightening, and policy rate increases, though he acknowledged that it "complicates the task of achieving a restrictive stance".

A soft landing remains possible

At several points during the press conference, Powell was pressed on the committee's outlook for a soft landing versus Fed staff's projection for a mild recession beginning later this year. While not pushing back against staff's forecast, Powell relied on the uniqueness of the current cycle and "excess demand in the labor market". He said that the large number of job openings – still 1.6 job openings per unemployed worker – means it is possible to reduce the number of job openings without significantly raising the unemployment rate. This is a view that the Fed has held for some time and has been articulated in public speeches, most eloquently, in our view, by Governor Waller. While acknowledging that this would go against prior business cycle outcomes, he concluded that a soft landing is more likely than a mild recession.

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