US Watch

# June FOMC quick reaction: None, but not done

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Macro
United States

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## Key takeaways

- As expected, the Fed stayed on hold at the June FOMC meeting.
- In the updated SEP, the Fed revised higher its outlook for growth in real GDP and core inflation in 2023.
- Based on the rise in the median dot for 2023, we expect the Fed to deliver another 25bp hikes in July and September.

## On hold, but a surprise terminal rate

The Fed met market expectations by staying on hold at the June FOMC meeting, but it surprised us with its median funds rate projection for 2023. The median committee member projects a median terminal target funds rate of 5.50-5.75%, 50bp higher than was the case in March, as opposed to our expectation for a 25bp increase. The median forecast for 4Q 24 rose to 4.5-4.75% in line with our expectation.

The FOMC statement now says that the committee held its policy rate steady “to allow the committee to assess additional information and its implications for monetary policy.” When taken in the context of Powell’s comments during the press conference about a preference for moving at a slower pace of rate hikes, this suggests the Fed may be prepared to take policy rate decisions on an every-other-meeting basis, though Powell was careful to keep his options open depending on the evolution of the data.

The statement also retained the language, as expected, about “determining the extent of which additional policy firming that may be appropriate,” which is consistent with upside bias to the policy rate path in the updated Summary of Economic Projections.

## Market reaction

The rates market perceived the Fed as hawkish with a front end rates sell-off & material flattening of the 2s10s & 5s30s curves. The initial market reaction was driven by the summary of economic projection dot plot, which showed the median ’23 dot higher by 50bps. A Fed signal of more hikes vs market expectations drove the hawkish Fed interpretation. The hawkish message was reflected by front end real rates leading the rate move & a flattening of the real rate curve.

USD moved moderately higher on the back of the FOMC in terms of immediate reactions, led by the dot plot’s indication of further rate hikes. The potential for more Fed tightening follows along the general pattern among central banks around the world, given the recent surprising rate hikes that we saw previously out of the Bank of Canada and the Reserve Bank of Australia. Moreover, after today’s FOMC, we will see the other major central banks in G4, with rate hikes expected out of the European Central Bank and the Bank of England.


**Refer to important disclosures on page 5 to 7.**
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## US Economics: On hold, but a surprise terminal rate

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### More growth, higher inflation, lower unemployment

In the updated Summary of Economic Projections, the Fed revised higher its outlook for growth in real GDP in 2023 to 1.0% 4Q/4Q, up from 0.4% previously. This was 0.3pp more than we had anticipated, but in line with our revised US outlook (see below). The path for headline inflation was largely unchanged, while the committee pushed up its forecast for core PCE inflation this year to 3.9% 4Q/4Q. We had expected it to rise to 3.8%. However, the median participant kept its forecast for core PCE inflation in 2024 and 2025 unchanged. Finally, the median member revised lower its outlook for the unemployment rate this year to 4.1%, from 4.5% previously.

### Why not just hike today?

In response to questions about the conflicting messages of staying on hold in June versus projecting two additional 25bp rate hikes before year end, Powell emphasized that risk management is playing an important role in the Fed's reaction function. He said what ultimately matters is the terminal rate as opposed to how quickly the Fed reaches it, and the committee is balancing its assessment of the incoming fundamental data, which the Fed sees as resilient and still inconsistent with inflation stability, and the evolution of banking sector stress and the view that monetary policy works with a lag.

Even with the median member projecting two additional rate hikes may be forthcoming, Chair Powell was reluctant to endorse the view that a rate hike should be expected in July. Instead, the chair said the committee would keep its options open and assess data at it arrived. In our view, data is likely to validate the median dot as we move into July.

## US Economics: We have revised our outlook for a delayed downturn and higher policy rates

We have taken on board the signal from an improved risk backdrop, resilient spending and employment, and upward revisions to construction spending and trade data, and push out our anticipated slowdown in the US economy by two quarters (see the report Resilient economy, higher policy rates, 14 June 2023). We expect growth in real GDP of 1.1% 4Q/4Q this year, up from -0.2% previously

For 2024, we now expect 4Q/4Q growth of 0.0% versus 0.9% previously. We think growth could turn negative for two quarters in 1H 24, but the depth of the downturn in our forecast is now more modest than before. If labor supply is rebounding, the gap between labor supply and labor demand is falling and should mean the Fed can achieve 2% outcomes with less adverse consequences. Our forecast is now as much a "growth recession" as it is a "mild recession".

In turn, we revise our outlook in favor of a more gradual back up in the unemployment rate and a slower pace of disinflation. We now forecast core PCE inflation to end the year 40bps higher at 3.8% 4Q/4Q and 20bps higher next year at 2.4% 4Q/4Q. We think price stability will be achieved in early 2025. We have the unemployment rate peaking at 4.7% in 4Q 24, a bit below our prior peak and three quarters delayed.

### A resilient economy to bring more Fed hikes

A longer period of labor market resilience and sticky inflation should mean more Fed hikes. We expect the Fed to deliver another 25bp hike in July. Moreover, our revised outlook suggests that by the end of the summer, job growth will still be running well above the "breakeven" pace of long-run labor force growth, and inflation will still be well above target. Therefore, we look for an additional 25bp hike in September for a terminal rate of 5.5-5.75%, though the Fed may decide the last hike should come in November per the Chair's guidance that the Fed would prefer to move every other meeting as it assesses the effects of prior rate hikes. Finally, we now think the first rate cut and the end to QT comes in May 2024, versus March 2024 in our previous forecast.

## US rates: hawkish dots, seeking "decisive drop with minimum damage"

The rates market perceived the Fed as hawkish with a front end rates sell-off & material flattening of the 2s10s & 5s30s curves. The initial market reaction was driven by the summary of economic projection dot plot, which showed the median '23 dot higher by 50bps. A Fed signal of more hikes vs market expectations drove the hawkish Fed interpretation. The hawkish message was reflected by front end real rates leading the rate move & a flattening of the real rate curve.

During the press conference the initial move in rates retraced partially. Powell reiterated that every meeting is live & there is no pre-set path the Fed has agreed to. He also suggested the Fed is seeking a decisive drop in inflation with minimum damage to the real economy. The more data dependent approach reiterated in the press conference may have contributed to a partial retracement of the initial rate move.

Overall, the June FOMC message suggests a Fed not yet done with hikes. As long as the Fed is hiking, clients should be careful with outright long duration position & the UST curve will be biased flatter. Our guidance to clients with a Fed still on a hiking path: (1) trade duration tactically in 10Y range of 3.25-3.75%, look to add duration longs around 4% (2) curve is biased flatter until macro slowdown or premature pause (3) use upside inflation exposure as a hedge to any outright duration long.

There was no change in Fed administered rates, as expected. IOR remained at 5.15% and ON RRP stayed at 5.05%. The Fed continues to give no indication of changes to setting of these rates in the target range or changes to per counterparty caps. When explicitly asked about changes to the setting of ON RRP terms Powell downplayed the possibility of any changes in the near term.

## FX: modest USD strength, with potential for more upside near-term

USD moved moderately higher on the back of the FOMC in terms of immediate reactions, led by the dot plot's indication of further rate hikes. The potential for more Fed tightening follows along the general pattern among central banks around the world, given the recent surprising rate hikes that we saw previously out of the Bank of Canada and the Reserve Bank of Australia. Moreover, after today's FOMC, we will see the other major central banks in G4, with rate hikes expected out of the European Central Bank and the Bank of England.

However, much of that initial USD-positive reaction unwound during Fed Chair Powell's press conference, similarly to the reaction in interest rates, really only leaving the USD modestly higher. The perverse market dynamic around higher inflation being good for currencies has worked through central bank action, while the impact of the press conference was to unwind some of that belief in Fed determination to hike more aggressively. Ultimately, the key issue over the medium term will remain whether the

Fed and other central banks can guide inflation lower quickly enough. And while inflation may be heading in the right direction lower, progress remains excruciatingly slow, leading to the risks for USD upside.

We remain modestly USD positive in the short-term, with the potential that the Fed's hiking cycle will continue on. While we still see the dollar overvalued for the longer-term, the fight against inflation in a strong economy is likely to remain a USD-positive force.

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