Liquid Insight

July FOMC: hike & seek

25 July 2023

Rates and Currencies Research
Global

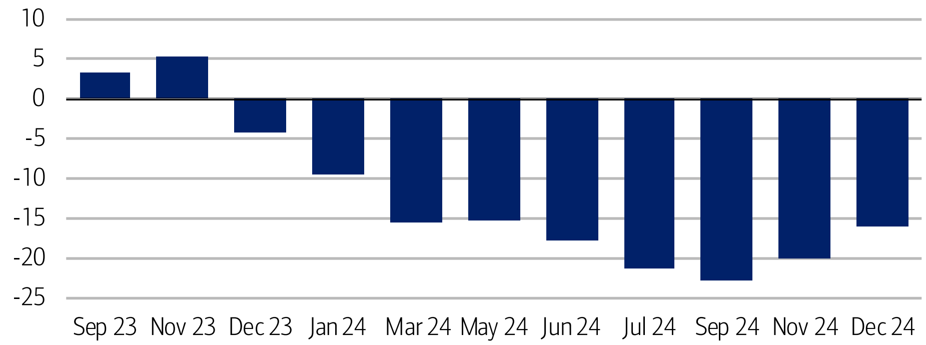
Key takeaways

- 25bps hike likely on Wed to 5.25-5.5%. Statement to keep existing guidance, Powell won't signal Fed is yet done tightening
- Rates likely to interpret FOMC communication as slightly hawkish; we like fading extent of rate cuts in late '23 & early '24
- FX unlikely to find new USD trend from July FOMC meeting; ECB & BoJ later in the week may be larger FX drivers

By FOMC: Mark Cabana, Michael Gapen & Alex Cohen

Exhibit 1: Hike or cuts by FOMC meeting date (bps)

After July, the rates market prices little risk of additional hikes & swift Fed cuts



Source: Bloomberg

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Fed likely to hike in July & seek further guidance from data

The Fed is likely to hike 25bps Wednesday, raising the target to 5.25-5.5%. The statement should keep existing rate guidance & we don't think the Fed is ready to signal it is done tightening. Powell presser to be key market focus, we look for 4 key communication messages: (1) 2% inflation is still the goal (2) lower inflation desired without undue harm to economy (3) further tightening still likely appropriate (4) data dependence.

July FOMC communications not likely to materially surprise rates or FX markets. Rates would likely interpret FOMC communication as slightly hawkish, simply because Powell will avoid sounding dovish & fueling rate cut pricing / fin condition easing. We like fading rate cuts in late '23 & early '24; Dec-Mar FOMC OIS steepener is our preferred trade.

For FX, July FOMC is unlikely to be a major trend-setting event for USD. ECB & BoJ may be larger FX drivers. A surprise tweak to YCC by the BOJ would likely see USD/JPY trade lower temporarily, and policy guidance beyond the fully priced 25bp ECB hike for June poses 2-way risk for the EUR.

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Economics: July FOMC preview = back in the saddle

After remaining on hold at its June FOMC meeting, we look for the Fed to raise the target range for the Federal funds rate by 25bps to 5.25-5.50%. The cooling of the economy is only happening slowly, and we think most committee members believe further rebalancing of supply and demand is needed to ensure disinflation will continue. Additionally, most Fed speakers appeared to endorse action at the July meeting during the intermeeting period.

While most FOMC members continue to monitor for signs of financial instability and a credit crunch in bank lending, the general message from policymakers during the intermeeting period was that bank behavior largely reflects monetary policy tightening and not stress. As such, most Fed members who spoke about banking sector stress expressed comfort with developments and said it was appropriate to continue policy rate tightening to cool activity and inflation.

The statement: retain upside bias

In addition to raising rates, we expect the FOMC statement to keep 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.” We don’t think the Fed is ready to signal it is done tightening.

Press conference: maximum optionality

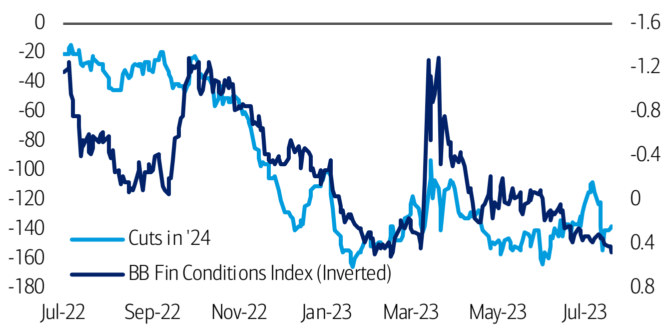
We look for four main messages in the press conference. First, the committee would do what's necessary to return inflation to 2% over time. Second, in bringing inflation down, the committee would prefer to avoid imposing undue harm to the economy. Slowing the pace of policy rate actions allows for fine tuning of the policy stance. Third, we think the Chair would not rule out further action, pointing to the June projections that indicated most members expected more than one hike before year-end would be appropriate. This would align with the guidance in the FOMC statement. Finally, we don’t think the Fed would want to be boxed in one way or another; we expect Powell would likely say that whether additional policy rate firming happens, and when it happens, will remain data dependent.

Rates: Powell won’t want to fuel rate cut speculation

The FOMC meeting isn’t likely to materially surprise the rates market. The Fed would likely hike 25bps, as widely expected. We expect Chair Powell would say further policy rate firming remains likely, though retain optionality for when or if (see July FOMC).

Exhibit 2: Financial conditions (RS, ppts) & ’23-’24 curve (LS, bps)

Financial conditions been highly correlated to ’24 rate cuts



Source: Bloomberg

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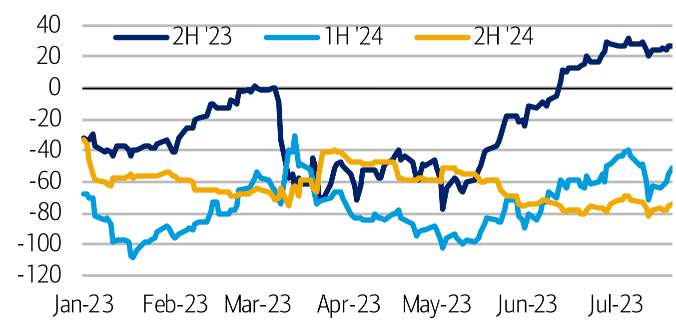
Exhibit 3: Rate hike or cuts by date (bps)

Expectations for cuts in 1 & 2H ’24 are driving easier fin conditions



Source: Bloomberg

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We think the rates market will likely interpret FOMC communication as slightly hawkish. The statement is unlikely to contain material surprises but think the press conference tone would be read as favoring further tightening. Powell is likely to reiterate Fed commitment to 2% inflation & more tightening likely appropriate, though stance data dependent.

Powell likely won't want to sound dovish. Financial conditions have been easing with pricing of '24 rate cuts (Exhibit 2). The Fed's most effective way to lean against '24 cuts is to keep alive possible rate hikes (Exhibit 3). Fed will keep this option live.

Our Fed expectations have 2 trading implications: (1) fade cuts in early '24; our preferred expression is Dec '23 – Mar '24 FOMC OIS steepening but could also be achieved via short Mar '24 FOMC OIS. Fast degradation in macro outlook is a risk to this trade. (2) trade cumulative hikes in Sept & Nov '23 in range of 5-15bps; the market is now 9bps and may test the upper end of this range post FOMC.

Overall, the July FOMC communications likely won't materially shift Fed expectations but are likely to be seen as slightly hawkish. Powell won't want to ease vs market pricing and would probably end up supporting higher rates through 4Q23 & 1Q24.

FX: Fed induced USD move unlikely post-selloff

Barring a major surprise, the July FOMC is unlikely to be a major trend-setting event for the USD. The USD has already depreciated notably coming into the meeting on back of the highly publicized soft June CPI report and first downside miss in NFP in 15 months. That said, overall US economic data across the spectrum has generally remained resilient. This— along with some dovish signals related to the ECB and BOJ— has contributed to the USD's partial retracement over the past week.

With a 25bps hike in Fed Funds all but assured and no SEP release, any market signals will need to be derived from language changes in the statement, and the nuances of Chair Powell's press conference. However, we see it as unlikely that the Fed delivers a forceful signal one way or another in a way that would produce a sustained move in the dollar. Their goal will likely be to counterbalance the acknowledgement of disinflationary signals with ongoing signs of resilient growth and overall tight labor markets. We expect the Fed to maintain policy flexibility/data dependency while keeping an upward rate bias in their outlook.

At the extremes, the USD could retrace further if the suite of communication downplays the June CPI report and reinforces the committee's forecasts for further hikes beyond July; in line with Governor Waller's recent comments. This would run counter to market pricing, which reflects expectations for a most likely terminal rate of 5.25-5.5%. Should Chair Powell emphasize the June CPI report as a clear inflection point, the dollar would likely depreciate as the market re-focused on reduced September/November expectations as well as early pricing of cuts. We see this as highly unlikely.

The Fed is just the first of the G3 central banks this week to meet, and the FX market will have a lot to digest in the coming days. A surprise tweak to YCC by the BOJ would likely see USD/JPY trade lower temporarily, and policy guidance beyond the fully priced 25bp ECB hike for June poses 2-way risk for the EUR.

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- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
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- Strong USD selling, **Liquid Cross Border Flows**, 17 July 2023

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