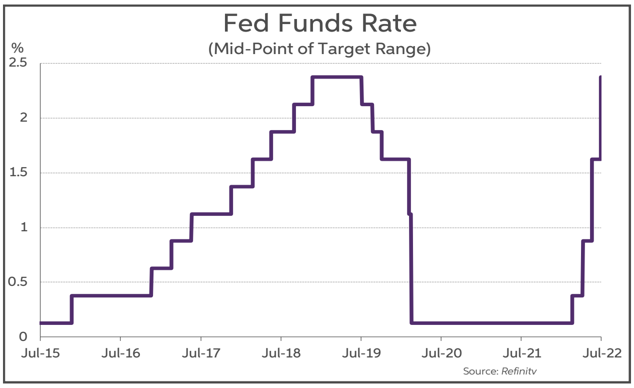
Fed Watch

AIB Treasury Economic Research Unit

28th July 2022

Fed hikes as expected, but no specific forward guidance

The July meeting of the US Federal Reserve saw the central bank announce its second consecutive 75bps rate hike, as it continues to try and bring inflation back down from its current elevated levels. The rate increase brings the target range for the Fed funds rate to 2.25-2.50%. The decision to raise rates by 75bps was unanimous. It was also in line with the guidance the Fed provided at its last meeting in June. This marks the fourth meeting in a row that the Fed has hiked rates. The Fed has now implemented 225bps worth of rate increases since it commenced its tightening cycle in March of this year.

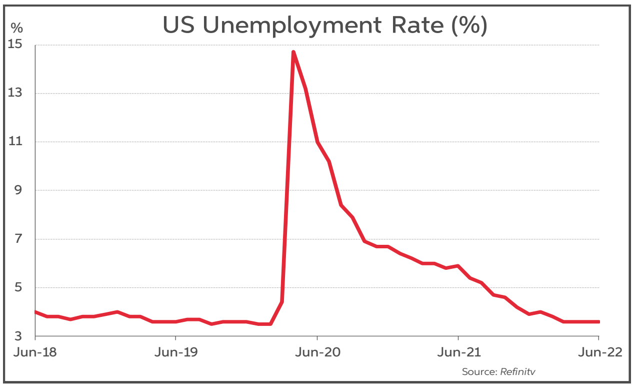


There were no major changes to the meeting statement. However, the Fed did acknowledge that incoming data has been showing some loss of momentum, noting that “recent indicators of spending and production have softened”. Although it continued to reference the fact that job growth has been robust over the last number of months.

With no updated macro forecasts or interest rate projections, the focus of Chair Powell’s press conference was on what guidance would be provided regarding its next policy meeting in September. In this regard, the Fed has stopped providing explicit guidance on the size of rate increases. Fed Chair Powell commented that the central bank envisages that “on-going increases” will be appropriate at upcoming meetings, but did not provide specific forecasts. Instead, he stated that the pace of increases will depend on incoming data and the evolving outlook for the US economy. He did not rule out another 75bps hike in September, commenting that “another unusually large increase” could be necessary. However, he indicated that it would likely be appropriate to slow the pace of increases from here. **In response to questions on its interest rate guidance, Chair Powell emphasised that the interest rate projections (i.e. ‘dot plot’) it provided in June were still relevant.** These projections showed the Fed’s anticipating the Feds funds rate getting to 3.375% by end 2022 and a peak of 3.75% next year. This would point to another 100bps in hikes this year and a further 40bps in 2023.

In terms of market expectations, futures contracts indicate that the market is close to the Fed’s projections for the remainder of this year. These contracts are consistent with a further 90bps of tightening, which would take rates up to 3.25% at end 2022. **The market has a notably different view on what will happen rates in 2023.** It does not see any further rate increases next year. Indeed, futures contracts are pricing in around 60bps of rate cuts during the second half of 2023. This would leave rates at 2.65% by end-23. This represents quite a softening of rate expectations. At the June meeting, the market was pricing rates peaking at 4% in early 2023, compared to 3.25% at the end of 2022 now.

The Fed faces a difficult balancing act in trying to tighten policy to slow activity sufficiently so that inflation is brought under control, but not to the extent that it tips the economy into recession. Chair Powell stated in the press conference that he “doesn't think the US is currently in a recession”, but that “its true that growth is slowing”. The Fed funds rate is now at the central bank’s own estimate of the neutral rate of 2.5%. There are eight weeks until its next meeting on September 21st. Therefore the incoming data, especially in relation to inflation, will be carefully assessed as the market tries to position itself for the magnitude of the rate increase for September. The Jackson Hole Economic Policy Symposium in late August will be closely followed for insight into the Fed’s mindset for the September meeting.



Following the meeting, US equities rallied, while Treasury yields fell and the dollar weakened. This implies the market views the latest Fed update as being less hawkish in tone. However, the Fed has clearly stated and guided that it will continue to hike rates, though the pace of tightening is likely to moderate.

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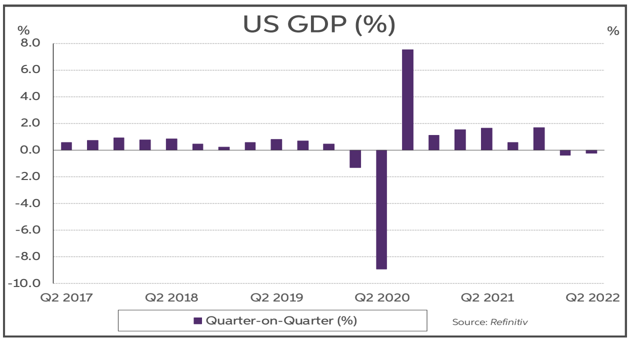
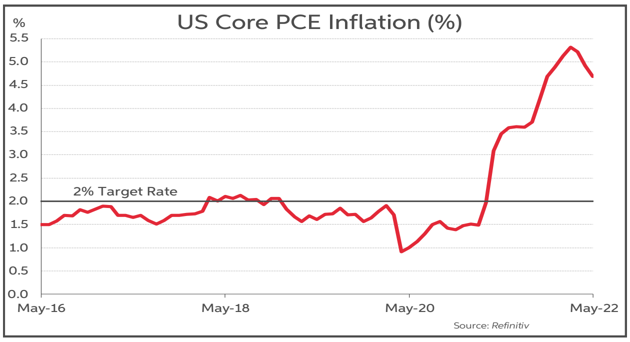
US economy loses further momentum over the summer

Having contracted by 1.6% in Q1, GDP declined by 0.9% in annualised terms in Q2. Regarding the breakdown for Q2, consumption rose by 1.0% in the quarter, contributing 0.7 percentage points (p.p.) to GDP. However fixed investment subtracted 0.7 p.p. from the total, largely due a 14% fall in residential investment. Government spending clipped a further 0.3 p.p. from growth. Meanwhile, inventories and net trade remained volatile, and knocked a combined 0.7 p.p. from output. Although the US has now recorded two consecutive contractions in GDP, the NBER Business Cycle Dating Committee is unlikely to declare that the US economy is in a recession, given the current strength of the US labour market. The decline in GDP in H1 is also mainly due to slower inventory accumulation. Real final GDP sales rose by 1.1% in Q2.



The limited survey data available for July, are consistent with a further contraction in activity at the start of Q3. The flash composite PMI reading moved below the key 50 threshold in July, falling to 47.5, its lowest level since June 2020. The services PMI moved into contraction territory for the first time since June 2020 also. The index fell sharply to 47.0 from 52.7 as growing inflationary concerns and relatively subdued demand weighed on activity. Although the flash manufacturing PMI remained in expansion mode, it fell for the third month running in July, to 52.3, its lowest level since July 2020. Worryingly, the output sub-component fell below 50 for the first time since the initial phase of the pandemic. New sales and export orders fell sharply also. Consumer sentiment has remained subdued in July as well. The Conference Board measure fell to 95.7, its lowest level since February 2021. Meantime, the University of Michigan survey - which has been around since 1946, and places a greater emphasis on household finances and spending plans - is at its second lowest level on record.

Meanwhile, headline inflation, which hit multi-decade highs in Q1, has continued to rise. In June, CPI inflation rose by 1.3% in the month, lifting the annual rate to 9.1%. However, the core CPI inflation rate fell for the third month running, to 5.9% in June, though the monthly increase was still high, at 0.7%. Headline and core-PCE inflation were at 6.3% and 4.7% in May. Inflation is expected to fall back over the second half of this year, most notably as the upward pressure on energy prices eases, and on favourable base effects in the core rate. Nevertheless, a move back to the 2% target level is likely to be slow. The latest projections, from the June Fed meeting, show core-PCE inflation easing to 4.3% in Q4 2022, 2.7% by Q4 2023 and 2.3% in Q4 2024.



In terms of the labour market, conditions are very tight. This is against the backdrop of continued strong job growth. Payrolls have been increasing at a rapid pace, rising by circa 2.7m so far in 2022. The unemployment rate has declined sharply, and stood at 3.6% in June. Labour force participation is still over 1p.p. below its pre-pandemic level though. Tight conditions in the labour market have placed upward pressure on wages, with average earnings 5.1% higher year-on-year in June. However, wage growth has moderated recently, with the rise in average hourly earnings averaging 0.4% over the past four months.

Having rebounded by a robust 5.7% in 2021, the US economy will grow much more slowly this year, and the risks of a recession are rising. Very high inflation is weighing on real household incomes and consumer spending power. The global economy has also weakened. Meantime, the Fed continues to tighten monetary policy very aggressively, while financial conditions have already tightened a lot. The housing market in particular is coming under pressure from higher interest rates. **There are some positives for the US economic outlook, though.** Savings have increased by $2.5trn more than their pre-COVID trend, and wages have risen the most for lower earners. Core inflation is showing tentative signs that it may have peaked also, which should alleviate some of the pressure on households. Overall though, growth forecasts are being revised lower. **The Fed sees GDP growth slowing to 1.7% y/y in Q4 2022 and remaining at 1.7% y/y in Q4 2023. Meanwhile, the IMF downgraded its GDP forecasts to 2.3% this year, falling to just 1% in 2023, amid the significant headwinds facing the economy.**

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