Fed Watch

AIB Treasury Economic Research Unit

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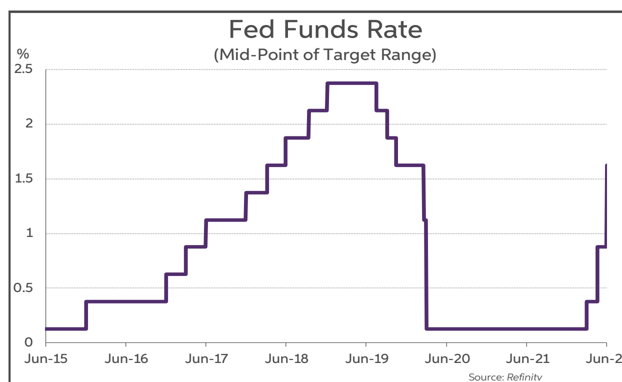
Fed hikes by 75bps, with plenty more to come

The US Federal Reserve delivered its first 75bps rate hike since 1994 at its FOMC meeting yesterday. The rate hike brought the target range for the Fed funds rate to 1.5-1.75% and followed the 50bps and 25bps rate increases at the last two policy meetings in May and March, respectively. It was the first time the Fed has hiked rates at three consecutive meetings since 2000. The decision was not unanimous, with one FOMC member voting for a 50bps hike. Chair Powell had stated at last month's policy meeting that the FOMC was not actively considering a 75bps move. However, the data released since then, especially the May CPI report, obviously caused a change of heart. **The 75bps move was signalled to the markets via well placed media sources at the start of this week**.

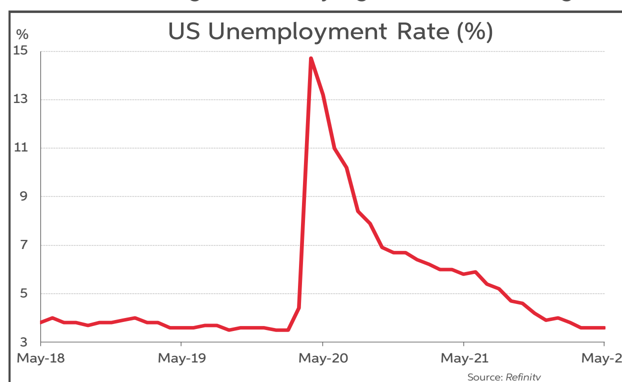


The Fed is on an aggressive policy tightening path as it seeks to rein in surging inflation, with the headline CPI rate climbing to a forty year high of 8.6% in May and the core CPI rate also very elevated at 6%. **The Fed has turned increasingly hawkish on policy in recent months.** The 'dot-plot' of the Fed's projected path for interest rates published yesterday sees them getting to 3.375% by end 2022 and a peak of 3.75% next year. In the previous 'dot-plot' in March, the Fed saw rates at 1.875% at end 2022 and 2.75% at end 2023. The new path implies further rate tightening of 175bps this year and 25-50bps in 2023. Chair Powell indicated that either a 50bps or 75bps hike seems most likely at the next meeting in July. Notably, all 18 FOMC members expect rates to go above 3% by end year.

The markets have been taking note of the Fed's hardening stance, with a series of rate hikes now priced in over the next three quarters. Futures contracts see the Fed funds rate being increased to circa 3.625% by end year, which implies a further 200bps of hikes in H2 2022. Rates are seen rising further to a peak of 4% in the first quarter of 2023. Thus, markets are pricing in somewhat greater tightening than the Fed. Both, though, exceed the last major Fed tightening cycle between Feb 1994 and Feb 1995, when rates were increased by 300bps from 3% to 6%.

The key challenge the Fed faces in tightening policy is to slow activity sufficiently that inflation is brought under control, but not to the extent that it tips the economy into recession. In this regard, financial conditions have already tightened considerably this year. Ten year Treasury yields have more than doubled, rising by almost 200bps from 1.5% to 3.4% since the end of 2021. Meantime, the S&P 500 stock market index is down over 20% year-to-date, there has been a significant widening of credit spreads, while the dollar has soared.

Achieving a soft landing for the economy has proved a difficult task for the Fed in the past, especially when bringing inflation down from elevated levels. Fed Chair Powell acknowledged this, saying the task "is not getting easier". He commented that "we're not trying to induce a recession now. Let's be clear about that" At the same time, the post-meeting statement was unambiguous in stating the Fed is strongly committed to returning inflation to its 2% target.



The updated Fed macro projections published yesterday show that it expects the economy to slow, but still grow at a moderate pace. GDP growth is forecast at 1.7% yoy in both Q4 2022 and Q4 2023 and 1.9% yoy for Q4 2024. This is slightly below trend so the unemployment rate is projected to rise to 4.1% by end 2024 from 3.6% currently. Meanwhile, headline PCE inflation is seen easing from 6.3% in April to 5.2% by Q4 2022. Both the headline and core PCE inflation rates are projected to fall to 2.7% in Q4 2023 and 2.25% by Q4 2024, still slightly above target.

The markets had moved in advance of the FOMC meeting, with stocks selling off sharply and bond yields jumping earlier in the week, on signals that a 75bps hike was on the cards. The initial post-meeting market reaction was a bounce in US equity markets, but **US stock futures point to a sharp fall in indices today as fears of a recession grow.**

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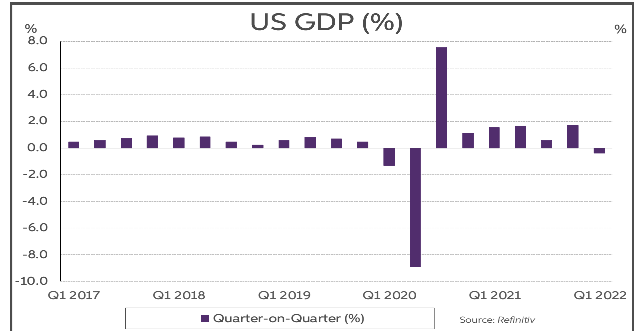
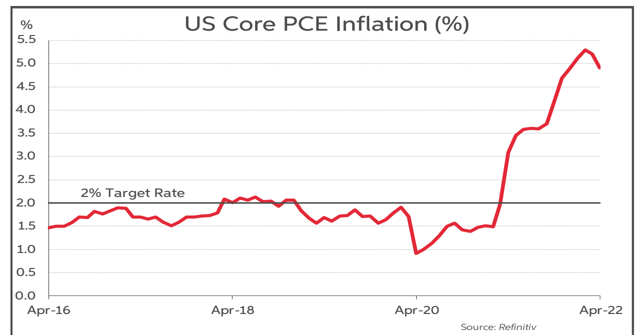
Economy on weakening path, but expected to avoid recession

US GDP contracted by 1.5% in annualised terms in the first quarter of the year. However, the headline rate masks continued solid growth in final domestic demand. Consumption rose by 3.1% in the quarter, contributing 2.1 percentage points (p.p.) to GDP, while fixed investment added a further 1.2 p.p.. A massive surge in imports though, as businesses continued to rebuild inventories, and a fall in exports meant that net trade subtracted 3.2 p.p. from growth. Meanwhile, although businesses continued to rebuild stock levels, they did so at a slower pace than in Q4, meaning inventories knocked 1.1 p.p. from GDP. Government spending clipped 0.5 p.p. from the total for the second consecutive quarter also.



Survey data suggest that activity has continued to grow solidly so far in Q2. Both the manufacturing and the services PMI moved lower in May, albeit they remained well above the key 50 threshold. Similarly, both the manufacturing and the non-manufacturing ISMs stayed comfortably in expansion mode in April and May. However, consumer confidence remains muted. The Conference Board measure of consumer confidence fell in May for the first time in four months. Meanwhile, the University of Michigan survey - which has been around since 1946, and places a greater emphasis on household finances and spending plans - is at an all-time low, as inflation continues to eat into real disposable incomes.

The available hard data for Q2 suggest that the economy may be losing some momentum. Core retail sales rose by 0.5% in May and 0.4% in April in value terms, barely keeping pace with inflation. Housing data have already clearly weakened in response to sharp increases in mortgage rates, with downtrends in housing starts and home sales. Industrial production, though, has proved to be more durable despite ongoing supply chain issues. Output rose by a further 1.1% in April, continuing the strong growth seen in the opening quarter of the year.



Meanwhile, inflation which had already hit multi-decade highs in Q1, has continued to rise. In May, CPI inflation rose by 1.0% in the month, lifting the annual rate to 8.6%. The core annual CPI inflation rate fell for the second month running to 6% in May, though the monthly increase was still worryingly high at 0.6%. Headline PCE and core-PCE inflation were at 6.3% and 4.9% in April. 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 decline back towards the 2% target level is likely to be slow. The latest projections, from the June Fed meeting, show core-PCE inflation declining to 4.3% in Q4 2022, 2.7% by Q4 2023 and 2.3% in Q4 2024.

A real inflation risk is rising wages as labour market conditions are very tight. In April, there were almost twice as many job openings as there were unemployed workers. This is partly due to the fact, that the latest data show that labour force participation is still 1 p.p. below its pre-pandemic level. Payrolls though, have been increasing at a rapid pace recently, rising by circa 2.4m so far in 2022. The unemployment rate has declined sharply, and stood at 3.6% in May. Tight conditions in the labour market have placed upward pressure on wages, with average earnings 5.2% higher year-on-year in May. However, wage growth has moderated recently, with the rise in average hourly earnings averaging 0.3% over the past four months.

Having rebounded by a robust 5.7% in 2021, the US economy will grow much more slowly this year. Very high inflation is weighing on real household incomes and consumer spending power. The global economy has also weakened. Meantime, the Fed is set to tighten monetary policy very aggressively this year, while financial conditions have tightened a lot. There are some grounds for optimism, though. Savings have increased by $2.5trn more than their pre-COVID trend, and wages have risen the most for lower earners amid a strong jobs market. Overall though, growth forecasts are being revised lower. **The OECD now sees GDP rising by 2.5% this year and 1.2% in 2023. The Fed sees GDP growth slowing to 1.7% by end 2022 and remaining at 1.7% by end 2023. The economy, then, is expected to avoid a recession, but the risk of one is rising as indicated by falling stock markets**

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