Fed holds policy steady: rate hikes remain “unlikely” despite lack of inflation progress

The Federal Reserve left its policy rate unchanged and argued its policy stance is "in a good place", but officials are concerned about the recent lack of progress on inflation. Rate hikes remain unlikely, but the Fed is prepared to leave interest rates at current levels until that progress is achieved or the jobs market clearly weakens

US Federal Reserve Chairman Jerome Powell

Fed keeps rates at 5.25-5.50%

As universally expected, the Federal Reserve has left the Fed funds target rate range at 5.25-5.50%. The decision was unanimous and was made pretty easy given inflation continues to run too hot for comfort, consumers are still spending strongly and the economy added more than 800,000 jobs in the first three months of the year.

In the accompanying statement they continue to acknowledge that “inflation has eased over the past year but remains elevated”, but they have added the caveat that “in recent months, there has been a lack of further progress toward the Committee's 2 percent inflation objective”. This is similar wording that Chair Powell used on 16 April and isn't an especially surprising addition to the statement. There is also a subtle change further on whereby risks to achieving their employment and inflation goals "have moved toward better balance over the past year". Previously they suggested the risks were "moving into better balance". The fact that they didn't change this more given three consecutive 0.4% month-on-month core CPI prints is mildly dovish it could be argued.

Policy stance is "in a good place"... "persuasive evidence" needed for a hike

At the press conference, Powell reiterated that he feels monetary policy is "restrictive" and that an interest rate hike is "unlikely", but that will be up to the data to determine – he would need "persuasive evidence" that monetary policy isn't tight enough. He then repeated that 16 April comment that gaining confidence inflation is coming down and they can cut interest rates is taking "longer than thought" and he doesn't know if it will be achieved this year. However, with inflation having moved below 3% he argues that the employment goal of the Fed comes back into focus. He says the current policy stance "is in a good place" and in response to a question of a risk of stagflation – weakening growth and high inflation – he doesn't see "the Stag or the Flation".

Rate cuts remain on the cards for 2024, but inflation progress and labour market softness is required

Markets are currently pricing little chance of any action at the 12 June FOMC meeting, 16bp of cuts by September and 35bp of cuts by December – this had been below 30bp ahead of the press conference. This is a remarkable swing given it was only three months ago that the market was fully discounting 150bp of rate cuts this year starting at the March FOMC meeting.

We are forecasting the first move coming at the September FOMC meeting with two further cuts in November and December versus the consensus forecast of 50bp of cuts this year. Business surveys suggest caution on the outlook for the economy is warranted while employment surveys point to a pronounced slowing in hiring in coming months. We also expect inflation to post more encouraging readings as cooler economic activity and subdued labour cost growth help dampen price pressures. However, to deliver a cut we would likely need to see at least three 0.2% MoM core inflation prints and the unemployment rate trend upwards to perhaps 4.2% or above. Given the current strength in the economic numbers the risks are skewed towards the Fed moving later and more slowly than we are currently forecasting.

Quantitative Tightening (QT) adjustment has the most direct influence on the bond market

The interesting aspect of the FOMC outcome directed especially to bonds is the slash in the monthly roll-off of Treasuries from $60bn per month to $25bn. That represents a material $35bn of potential reinvestment back out the curve on the theory that the $60bn roll-off could have been maintained. By implication, any such re-investment would be done in a maturity weighted manner. In other words the sizes of reinvestment would be done in a manner that reflects outstanding issuance by maturity. We assume this is the case unless the Fed were to say something different. This is a net positive for bonds, and net neutral for the curve, albeit marginally in favour of the long end.

With respect to the MBS roll-off, there is no change in the official roll-off target (still $35bn). However, over the past year this has actually been running at around $16.5bn per month. The slower roll-off reflects slower underlying mortgage prepayments. By implication, it would not be inconceivable for the Fed to do in excess of $35bn per month should pre-payments accelerate in the future; for example when the Fed starts to cut rates (encouraging some more prepayment). The Fed has not been clear on how they would deal with a pre-payment spurt, but they have also not ruled out quicker toll-offs on MBS where possible (to help recover lost ground).

Bottom line though, we maintain our view that the decrease in roll-off is quite anticipatory. We continue to identify an excess of liquidity in the system, comfortably in excess of $750bn. The latest data show $500bn going back to the Fed on the reverse repo facility, which is the market posting liquidity back to the Fed. And bank reserves are still some $250bn above the $3tr market above which they are seen as ample. On the lower monthly numbers, the Fed will continue with QT right through 2024 and well into 2025.

Powell’s dovishness softens the dollar

Very modest and subtle changes to the FOMC statement saw the dollar slightly lower at first. It looked like investors had been positioned for less dovish communication and that the statement did not meet those expectations. And risk assets initially felt relieved, with S&P 500 futures rising a modest 0.25%.

The FX market reaction through the press conference saw the dollar continue to soften. Key remarks weighing on the dollar seemed to be those referring to longer term inflation expectations remaining well-anchored, a hike being "unlikely" and a reiteration of Chair Powell’s view that inflation would slow through the year – although his confidence in that view was lower. Additionally, his answer that weaker JOLTS data showed restrictive policy was working also seemed to knock the dollar lower.

The dollar also took its cue from the 10bp decline in short-dated US yields and the near 1% rally in S&P equity futures.

This now marks the fourth consecutive FOMC press conference where the dollar has ended lower on the day. Yet, earlier the DXY was close to the highs of the year. This serves as a reminder that it will be the data, not Fed communication driving the dollar. Unless inflation slows consistently, or unemployment picks up – let’s see what the April payrolls data delivers – the case for holding the dollar remains reasonably strong.

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