Federal Reserve minutes: Higher... but not too high!

The minutes to the Federal Reserve's July FOMC meeting point to ongoing rate hikes to ensure that inflation and inflation expectations don't become embedded. However, "many" participants fear they could end up going too far into restrictive territory, which suggests a clear chance the Fed ends up reversing course next year

Federal Reserve

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Rates to rise further, but more slowly

The minutes to the July Federal Open Market Committee meeting suggest the Fed will remain on a tightening path, but there are signs some officials are getting a little nervous that they could end up going too hard and may need to reverse course eventually. "Ongoing increases in the target range for the federal funds rate would be appropriate" with policy needing to move to a "restrictive stance", but that "it likely would become appropriate at some point to slow the pace of policy rate increases".

That is as hawkish as it gets. No discussion it seems of a once mooted 100bp hike for July. Instead, there is an acknowledgement from "a number of participants" regarding signs that the economy was reacting to policy actions "more rapidly than had historically been the case". While recognising the need to prevent inflation from becoming entrenched, "many participants remarked… there was also a risk that the Committee could tighten the stance of policy by more than necessary to restore price stability".

50bp and 75bp still in play for September, but growing chance of 2023 cuts

There is no real forward-looking guidance unlike the June minutes when the Fed suggested July was either going to be a 50bp or a 75bp hike. We have another jobs report and another CPI report plus the Fed's Jackson Hole conference starting next week so there will be plenty of chance for the Fed to try to shape expectations. It is still all to play for with the market continuing to hedge its bets, pricing 63bp of hikes at the September FOMC meeting.

We are still saying 50bp September, 50bp November and 25bp December, but if we got another 350k jobs print for August and CPI failed to show any moderation from the 8.5% headline and 5.9% core then we would likely switch to a 75bp call for September. However, we do worry that the growth outlook will deteriorate markedly after what should be a decent 3Q GDP print. A China slowdown, European recession and a domestic US housing downturn look set to push the US closer to what might feel like a "real" recession with rate cuts looking a distinct possibility for mid-2023.

Three things stand out from a markets perspective

1. The Fed thinks that real rates are still too low, even as they deem the nominal fed funds rate as being now at a neutral level. Ammunition there for expectations for higher nominal market rates, even though the impact reaction has been to test lower for rates, and for the belly of the curve to richen.

2. The Feds seems to be all over the place when assessing where financial conditions are. They note they are much tighter now (which is true versus where they were at the end of 2021), but at the same time note a relative ease to get access to credit and decent demand for it (which is indicative of a loosening in conditions). Since the minutes, financial conditions have loosened further; not ideal for a Fed that wants to tighten.

3. The Fed seems happy with the functioning of the reverse repo window, at which there is a 2.3% rate on offer. They also note that the doubling in the balance sheet roll-off volumes in the months ahead should ease the usage on the facility. We are certainly beginning to see this, as the usage seems to have plateaued, albeit from staggeringly high levels.

Overall, the market has seen yields fall a tad on the back of the minutes, but not in a dramatic fashion. Looking through this and focusing more on the Fed need to in fact tighten conditions further, market rates should be forced higher despite the impact effect seen.

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