Hawkish hold from the Fed offers maximum flexibility

The Federal Reserve leaves US interest rates unchanged but signals more hikes are on the cards with some hawkish projections for the economy. July is a 'live' meeting, according to Powell, but a one-meeting pause makes little sense given the long lags involved with monetary policy. With the disinflationary trend set to accelerate, we see an extended pause

Fed Chair, Jerome Powell, at today's news conference

Dovish action, but hawkish talk

After ten consecutive rate rises over the past 15 months, the Federal Reserve has left the Fed Funds target rate unchanged at 5-5.25%. This was the widely expected outcome after yesterday's CPI report, and today's PPI data resulted in just 2-3b basis points of hikes priced ahead of time, while only 6 out of 109 organisations polled by Bloomberg expected a hike.

This was a unanimous decision despite several of the hawks talking up the need for further rate hikes in advance. However, they clearly made their views known with the accompanying updated forecasts taking a decidedly hawkish tone. The March dot plot indicates rates had probably peaked, but these June forecasts show that two further rate rises are the expectation before they reverse course in 2024 with 100bp of rate cuts. Looking at the individual numbers, nine members expect 50bp of hikes, with two looking for 75bp hikes and one looking for 100bp. Four members expect one hike, and just two look for rates to be held steady through to the end of the year.

To rationalise this, they've revised up their fourth quarter Year-on-Year GDP growth from 0.4% to 1% and lowered their 4Q unemployment rate forecast from 4.5% to 4.1%. They have also revised higher the 4Q core PCE deflator to 3.9% from 3.6%.

Federal Reserve forecasts

	2023	2024	2025	Longer run
Change in real GDP (Jun Fed forecast)	**1**	**1.1**	**1.8**	**1.8**
Previous Fed projection (Mar)	0.4	1.2	1.9	1.8
Unemployment rate (Jun Fed forecast)	**4.1**	**4.5**	**4.5**	**4.0**
Previous Fed projection (Mar)	4.5	4.6	4.6	4.0
Core PCE inflation (Jun Fed forecast)	**3.9**	**2.6**	**2.2**	**-**
Previous Fed projection (Mar)	3.6	2.6	2.1	-
Federal funds rate (Jun Fed forecast)	**5.6**	**4.6**	**3.4**	**2.5**
Previous Fed projection (Mar)	5.1	4.3	3.1	2.5

Source: Federal Reserve, ING

If that's what they really believe, why not just hike?

The breadth of hawkishness is a surprise. They state that the data will determine what happens next, but given these projections, the question arises: if you think policy isn't tight enough, why not hike now?

Chair Jerome Powell (pictured at today's news conference), like all other central banks, has repeatedly stated that monetary policy operates with long and varied lags - he did so again in the press conference. The Bank of Canada, for example, explicitly states on its website that the full effect of a rate hike isn't felt for 18-24 months. That is the whole point behind a pause; you give yourself a bit more time to assess the impact. Given this backdrop, a 1-month pause - not hiking in June, but hiking in July - makes little sense. Markets also seem a little sceptical, with my screen showing 17bp priced now for July, up from 16 before the decision and 20bp priced for September. It is understandable that cuts previously priced are no longer there, though.

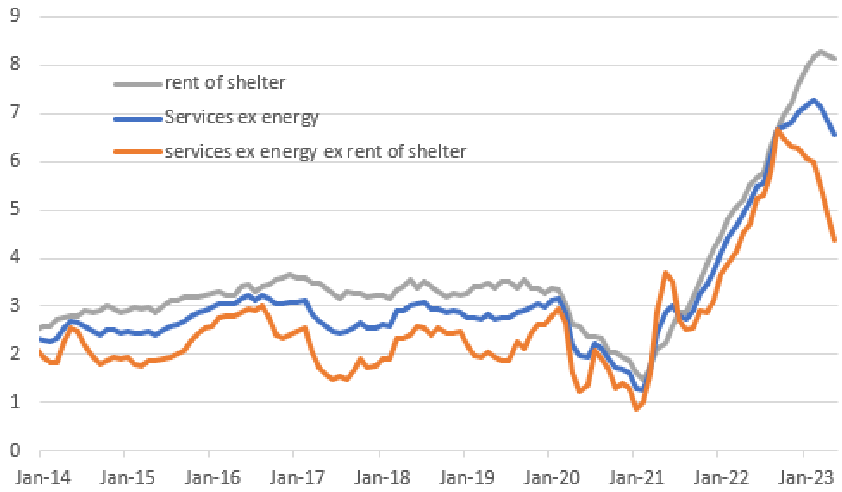
The way we would rationalise this outcome is that the Fed acting dovishly (unanimous pause) but talking hawkishly (pencilling in 2 hikes) gives them maximum flexibility to respond to the incoming data. It keeps monetary conditions tight, but they can turn dovish and jawbone things looser should the data turns out as we expect.

Disinflation trend will accelerate; expect the pause to be extended

We were really encouraged by the composition of yesterday's CPI report, with signs of softness coming through in the core services, excluding the cost of shelter, which the Fed has been paying close attention to. This area, where the fear has been that a tight labour market could keep inflation pressures elevated and inflation most sticky, slowed sharply, as the chart below shows. With rents slowing and used car prices set to fall sharply, we see the potential for core inflation to slow to close to 3%YoY by the end of the year.

With regard to headline inflation, we had been looking for 0.2%MoM / 3.1% for June, but today's PPI number coupled with oil price moves means we could potentially be talking 0%MoM / 2.9%YoY. Getting consumer price inflation with a 2% handle next month, having been above 9% 12-months ago, would be a huge story, and if we get a bit of softness coming through on the activity side, it could be challenging for Fed to justify restarting rate hikes.

Fed's inflation focus metrics are turning lower (YoY%)



Source: Macrobond, ING

By the time of the 20 September FOMC meeting, we think the Fed will have enough evidence to be pretty confident that inflation is firmly on the path to 2%, and that meeting will also coincide with the rough restart date for student loan repayments after a three-year pause. This will be a huge financial hit to more than 40 million people, which could have a severe impact on spending. We also think that the ongoing effects of previous rate hikes and the hit from tighter lending conditions will be more apparent in the data, and that will be the catalyst for the Fed to signal rates aren't going any higher.

Market rates have enough here to push higher, and the front end will feel tighter

The Fed has latched on to the theme that has dominated the market mindset in the past number of weeks, namely that the US economy continues to refuse to lie down. This has helped risk assets, as by implication, default risks that would typically evolve from a recession have been kept at bay, and that's helped credit spreads to tighten and equity markets to perform. There has also been an easing in measures of system risk, especially as immediate banking sector angst has been downsized. This overall combination has allowed market rates to ease higher, driven by higher real rates, which in turn are a sign of strength.

Initial comments from the Fed do not negate these themes and, in fact, push for more of the same. While this is more reflective of the new "dots" than anything else, it, in any case, pushes in the direction of higher market rates ahead. We continue to position for the 10yr to head to the 4% area, and it would not look wrong if it were to drift above for a period, at least until the illusive macro slowdown is a tad more clear cut than now. We still expect the 10yr to be much closer to 3% by the end of the year, but we trade that view a bit later. For now, we continue to play this from the short side (for bonds, implying higher yields).

No particular mention of the changing liquidity circumstances. Currently, we have ample liquidity, with bank reserves actually on the rise (up from US$3trn to 3.4trn) and still over US$2trn going back to the Fed on the reverse repo facility. The US Treasury has only slowly rebuilt its cash balance at the Fed since the debt ceiling was suspended, so the impact of fewer prior bills issuance and more bank support has dominated the ongoing quantitative tightening program. Ahead, some US$500bn of liquidity will get drained from the system as the Treasury rebuilds its balance through net bills issuance. Expect from that a combination of lower bank reserves and lower cash on the reverse repo facility.

This will make it feel like there has been some tightening in conditions, even if not in levels (as the Fed has not hiked).

Dollar bulls can hang on to the Dot Plot

We had called for a hawkish hold to come to the support of the dollar, and that has been the case. The channel used by the Fed to express that hawkishness was the significant revision higher in the 2023 Dot Plot projections, which from now on can work as an anchor for rate expectations and probably prevent a material dollar correction as long as data don't point clearly to a declining growth/inflation outlook.

This is also what can further delay the rotation towards European currencies that we had started to see in the past few days as hawkish Fed expectations cooled off. That's why the likes of the high-beta European currencies NOK and SEK are the worst-performing currencies after the FOMC announcement. We struggle to see the environment turning dramatically for the better for those currencies or for the euro in the near term, as the threat of a July hike by the Fed has been very much fuelled by the hawkish Dot Plot.

A return to >104 end-of-May highs in DXY is surely possible, especially given the ECB may struggle to surprise on the hawkish side on Thursday. In the medium term, we still expect a deterioration in US data will force the Fed to cut rates before year-end and take the rate-sensitive dollar sharply lower, but that is clearly not a near-term story after today's Fed announcement.

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