What to expect at the June FOMC meeting

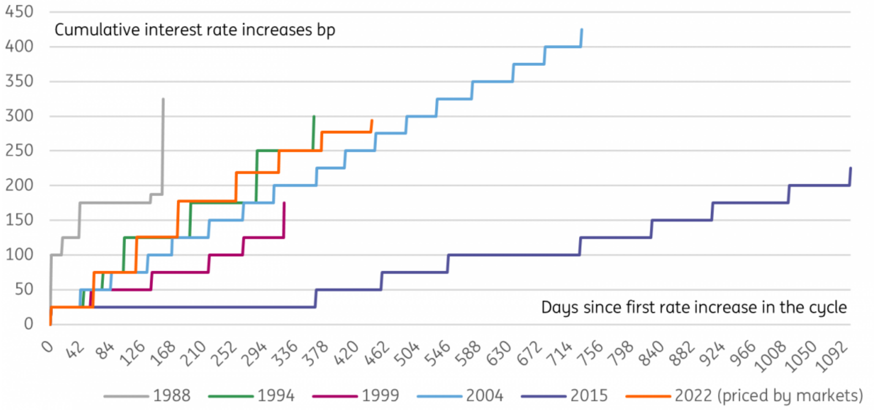
With the near-term growth story looking robust and inflation remaining well above target, the Federal Reserve is set to hike by another 50bp and confirm that a further 50bp move in July remains on the cards. Another hawkish set of Fed dot plots should keep the dollar supported near the highs of the year

50,50,50

The Federal Reserve is widely expected to follow up May's 50bp interest rate increase with another 50bp hike at the forthcoming FOMC meeting, taking the Fed funds target range to 1.25%-1.5%. During the press conference, Fed Chair Jerome Powell is set to confirm that a third consecutive 50bp hike in July is the most likely path ahead. The Fed is also expected to continue to allow $30bn of Treasury securities and $17.5bn of agency mortgage-backed securities to mature and roll off the balance sheet, increasing to $60bn of Treasuries and $35bn of MBS by September.

The market is pricing little prospect of a surprise given officials have made it clear that fighting inflation is the Fed's focus and the near-term growth story remains in decent shape. While household incomes are failing to keep pace with the increasing cost of living, consumers appear willing to run down some of their accumulated savings to maintain their lifestyles. The investment backdrop is also good while net trade is set to make a positive contribution to 2Q GDP growth with a 4% annualised expansion on the cards. At the same time, inflation is well above target and the Fed has acknowledged the need to get a firm grip on the situation, hence the guidance - set to be repeated - about the strong prospect of another 50bp move in July.

Current Fed cycle is not particularly severe



Source: US Federal Reserve

But September is much less clear cut

However, there is a debate as to what happens thereafter. Some officials want the Fed to continue with 50bp hikes to ensure inflation is brought under control, but this risks moving policy deeply into restrictive territory and heightening the chances of a recession. Others argue that there is already evidence of the growth outlook weakening and inflation pressures tentatively softening, which could justify a pause in September.

Consequently, we will be keeping a close eye on the Fed's updated forecasts and their "dot plot" diagram, which neatly illustrates the dispersion of views around the central tendency forecast for the mid-point of the target range. In March, this was for the Fed funds rate to end the year at 1.9% before reaching 2.8% for end-2023 and end-2024. It was then expected to drop back to 2.4% over the longer run.

Despite some talk of a pause (most notably from Raphael Bostic of the Atlanta Fed) we feel the growth, jobs and inflation backdrop will keep the hawks in the ascendency, though at the same time, the conviction of ongoing 50bp is not strong. Housing numbers are softening, the wage figures have not been as inflationary as many thought and the strong dollar and higher longer-dated Treasury yields are also helping to tighten financial conditions.

The end-2022 Fed funds prediction will inevitably rise given the Fed's more hawkish shift since March – remember back then the Russian invasion of Ukraine had led them to tread cautiously with a 25bp initial rate hike. We expect the central projection to rise to a minimum of 2.6% given the market is already pricing 2.75-3%. We strongly suspect the end-2023 number will get up to 3%, and the long run may be raised marginally to 2.5%.

What to expect from the new set of FOMC forecasts

	2022	2023	2024	Longer run
Change in real GDP (ING expectation)	2.8	2.0	2.0	1.8
Previous Fed projection (Mar)	2.8	2.2	2.0	1.8
Unemployment rate (ING expectation)	3.5	3.6	3.7	4.0
Previous Fed projection (Mar)	3.5	3.5	3.6	4.0
Core PCE inflation (ING expectation)	4.3	2.6	2.2	-
Previous Fed projection (Mar)	4.1	2.6	2.3	-
Federal funds rate (ING expectation)	2.6	3.0	2.8	2.5
Previous Fed projection (Mar)	1.9	2.8	2.8	2.4

Source: US Federal Reserve, ING forecasts

All set for 3%, but it may not last long

Our view is that the Fed will hike rates by 50bp in July, but switch to 25bp increments thereafter given the prospect of slower growth, moderating inflation (albeit slowly), and the fact the Fed's balance sheet reduction will also be doing some of the work to tighten monetary policy. We look for the peak at 3% in 1Q 2023.

Looking further ahead, we have to remember that the Fed doesn't leave policy in "restrictive" territory for very long – the average period between the last rate hike in a cycle and the first interest rate cut has only averaged around seven months over the past 50 years. If we are right, the combination of the Fed stepping on the brakes and cooling demand, coupled with supply-side improvements in the form of healing supply chains and increased worker supply should help to get inflation moving meaningfully towards the 2% target through the second half of 2023. This could pave the way for the Fed to consider moving policy to a more neutral footing in late 2023.

Hawkish FOMC to keep the dollar bid

The dollar heads into Wednesday's FOMC meeting at just off 1% from its highs of the year. May's soft patch for both short-term US interest rates and the dollar is quickly fading into the past and a hawkish FOMC meeting should keep the dollar supported near the highs.

Recall that the turnaround in the weak dollar trend really started in June 2021 when the Fed dot plots suggested the Fed was ready to normalise policy and ditch Average Inflation Targeting. Upward revisions to dot plots on Wednesday should again remind us that the Fed is in the early to middle stages of its tightening cycle.

And looking around the world, one can argue that the Fed would still be closer to the camp looking to take rates into restrictive territory rather than the likes of Brazil and somewhat surprisingly Poland, which are telling us that they are in the late stages of their tightening cycles.

A Fed focused on driving US real rates higher should be positive for the dollar and negative for growth-sensitive currencies and especially those on the wrong side of the energy ledger. The weak performance of the euro after a hawkish European Central Bank meeting warns that growth differentials could be starting to play a role in FX pricing. A strong dollar this summer could see EUR/USD lurch towards the lower end of something like a 1.02-1.08 trading range. USD/JPY should stay bid near 135, but we are certainly getting closer to Japanese unilateral intervention to support the yen. Cable could easily trade back to 1.22 given that the Bank of England cycle looks far too aggressively priced.

Higher US real rates will create headwinds for emerging market currencies – even those back by commodity exports. We continue to favour outperformance by the Mexican peso as Banxico tightens rates 'more forcefully'. The stronger dollar will also ask more questions of the beleaguered Chinese renminbi. We favour USD/CNY exiting its 6.65-6.80 range to the upside over the coming months.

Authors

James Knightley
Chief International Economist, US
james.knightley@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

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