Fed Watch

Fed signals it will move on to a slower hiking pace

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Bringing inflation down to 2% remains the top priority: the risk of doing too little outweighs that of doing too much

- **The Fed delivered a 75 bps rate hike today as widely expected by market participants, us included** (see). This was the fourth hike since the Fed started its tightening cycle last March (with a 25 bps hike) after keeping the effective policy rate close to 0% for nearly two years in response to the pandemic. With today's hike, the fed funds rate reached a 2.25-2.50% target range, which is consistent with the median FOMC estimate of the long-run neutral rate. Though financial conditions have been tightening even since the early stages of the current cycle of policy normalization as the Fed conveyed with its forward guidance its plans to remove monetary accommodation, today's decision marks the end of the repeatedly outlined goal to "expeditiously" bring the policy rate to its long-term neutral level, which would give the Fed and the markets better prospects for assessing the additional degree of tightening that will be needed to return inflation back to its target level or, in today's Chair Powell words, to "assess how our cumulative policy adjustments are affecting the economy and inflation". Changes to the wording of the statement have no significant implications for monetary policy in the short term, but the tone related to the assessment of the economy was more downbeat: "recent indicators of spending and production have softened", compared to the previous statement when the FOMC noted that "economic activity appear[ed] to have picked up". The Fed also pointed to "robust job gains" while the unemployment rate has remained low.

- **The Fed would rather take the risk of a hard-landing outcome than allowing inflation to become "entrenched".** The message from the Fed was straightforward: inflation remains as the top priority and will remain so in the foreseeable future. Chair Powell insisted that there is a path to bring inflation down while sustaining a strong labor market (i.e., a path for a "soft landing") but recognized that it "has clearly narrowed" and acknowledged that "it might narrow further". Although the tone on the growth outlook was clearly more downbeat, when asked about the risks of doing too much, Chair Powell seized the question to send a strong signal about the Fed's commitment to bring inflation back down. He said that "price stability is the bedrock of the economy" and that it is "what makes the whole economy work", adding that without restoring price stability the efforts to "sustain a strong labor market" over the medium and long term would prove useless. More importantly, he said that the risk of doing too little only raises the costs later, and thus, the Fed is going to avoid the risk of inflation becoming "entrenched" and is going to address it now. The message is clear: "the labor market is extremely tight and inflation is much too high", so the Fed will continue to raise rates to a moderately restrictive level until it feels confident that inflation is coming back down to target. **The risk of doing too little outweighs the risk of doing too much, and thus, ongoing rate increases will continue…**

- **… but "it likely will become appropriate to slow the pace [...]".** The Fed is set to shift to a meeting-by-meeting approach in September when setting the size of rate hikes. Although Chair Powell was careful and left the door wide open for another "unusual" 75 bps hike if warranted by economic data, **the Fed sent two signals today**, as we anticipated (see): **1) more hikes are coming:** a series of additional hikes to bring rates beyond the long-run neutral level in the following months to slow growth below potential, but **2) the**

tightening pace will slow in the coming meetings. The signals were clear: the job is not close to being done, and although avoiding a recession has become more challenging, the Fed thinks that additional rate hikes will be warranted in order to bring inflation down.

- **We stick with our forecast that the Fed will take the fed funds rate to a 3.25-3.50% target range by the end of this year, which will imply a shift to slow the pace of rate increases to a 50 bps hike in September, followed by two consecutive 25 bps hikes in November and December.** We continue to expect the fed funds rate to peak at 3.75-4.00% in 1H23 as we anticipate that core inflation will still show signs of stickiness by then. Yet, the path for monetary policy in 2023 and beyond is becoming much more uncertain as risks to the outlook will likely become more two-sided. Increased odds of a recession in 2023 will make the Fed's job more challenging. Uncertainty around the Fed steps in 2023 will rise, but for the time being, the most likely scenario is still that the Fed will have the need to stick to the series of additional rate hikes that seem more plausible for the median of Fed officials in the latest update of the Summary of Economic Projections (SEP). During the eight weeks between today's decision and the one to be taken next September there will be two additional inflation prints, two additional employment readings, a significant amount of economic indicators on the real economy, more information on the geopolitical developments, and a fresh update of SEP submissions by FOMC participants, which could give the Fed more confidence to outline a clearer path for its tightening pace going forward.

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