Fed Watch

The Fed will deliver a second 75 bps hike that will take the policy rate to its longer-run neutral level

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Although the pathway to achieve a soft landing has evolved from "likely" to "plausible", the tightening cycle still has legs

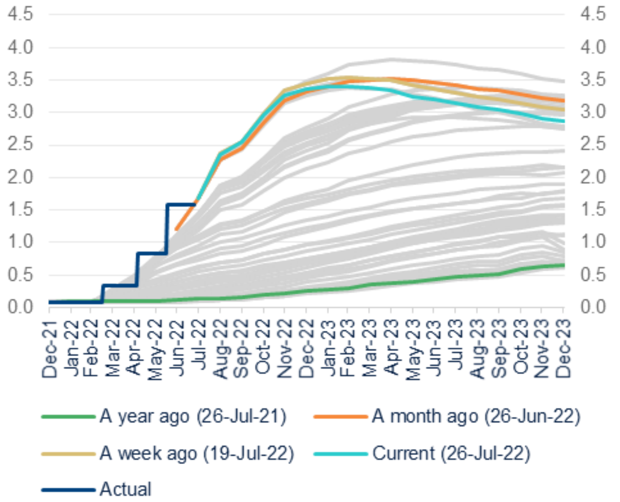
- **We expect the Fed to deliver a 75 bps rate hike tomorrow, wrapping up its early signaled plan outlined several months ago to "expeditiously" take the fed funds rate to its longer-run neutral level.** This move will place the policy rate in the 2.25-2.50% target range, a level that is consistent with the median FOMC estimate of the neutral fed funds rate. At its last meeting press conference, Chair Powell signaled that the July meeting would involve a debate between hiking 50 or 75 bps, but a shift back to 50 bps this month became unlikely with inflation soaring to 9.1% YoY in June and the economy adding 327,000 new jobs in the same month. Shortly after the June CPI data release, the odds of a larger (100 bps) hike climbed up to 80% (for more see). However, the implied probability of such a move dropped in the following days as some Fed officials signaled a second consecutive 75 bps hike (Table 1) and economic activity data came in on the weaker side. Odds today are 4 to 1 for a 75 bps rate hike as implied by the futures markets (Figure 1).

- **A series of additional hikes is planned beyond this meeting, but with recession risks on the upside, we expect the Fed to signal that it will slow the pace of tightening in the coming meetings.** The Fed has pivoted twice during this hiking cycle: the first when it implicitly recognized that it was too slow to start raising rates, and the second when it stepped up its tightening cycle with inflation soaring to new highs and far from giving signals or stabilizing (as we described here). Looking ahead, inflation will remain as the Fed's top priority in the short term because their credibility and the continued anchoring of long-term inflation expectations are at stake. These issues will continue to weigh more heavily on their short term decisions aimed at bringing down inflation by slowing demand while avoiding long-term inflation expectations from de-anchoring.

- **We expect the Fed to give some signals on its plan to hike beyond the long-run neutral level in the following months, which will likely imply shifting down to a slower pace of tightening.** The increasing likelihood of an upcoming recession will start to weigh more on the public debate. Although the Atlanta Fed GDPNow estimate signals a strong probability that real GDP will likely contract for the second quarter in a row (see), the economy is still not showing signs of broad-based weakness. Several FOMC members have recognized that recession risks have increased and that the path to a "soft landing" has narrowed considerably, but up to now, they have remained generally optimistic as a strong labor market puzzles the not-yet-convincing evidence of a faltering economy. We thus think that the Fed is not likely to change its planned series of additional hikes in the short term by either being scared off by upcoming consistent slowdown signals in the real economy nor reacting rashly to relatively high volatility in financial markets or inevitable yield curve inversions (Figure 3), as a return of the so-called "fed put" seems now a distant possibility given the current focus on getting inflation under control. This means that bouts of volatility such as those seen recently in the Treasury market (Figure 2) are here to stay for a while.

Odds today are 4 to 1 for a 75 bps rate hike tomorrow as implied by the futures markets

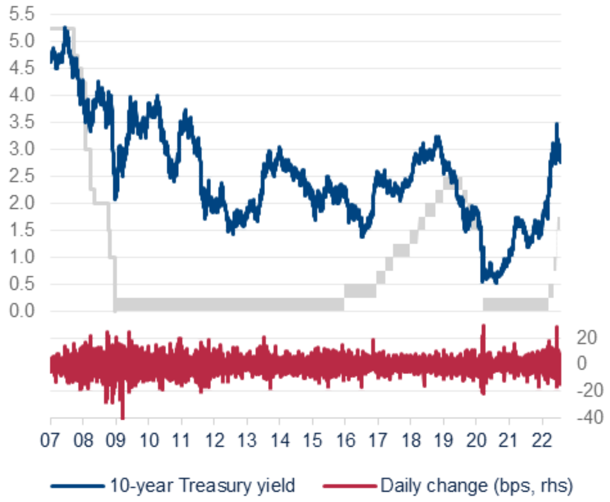
Figure 1. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (DAILY DATA, %)



The gray lines indicate weekly implied rate paths from a year ago.
Source: BBVA Research based on data by Bloomberg.

Bouts of volatility such as those seen recently in the Treasury market are here to stay for a while

Figure 2. **10-YEAR TREASURY YIELD DAILY CHANGE** (CONSTANT MAT., DAILY DATA, % AND BPS)



The gray line and area indicate the federal funds rate target.
Source: BBVA Research based on data by Haver Analytics.

The Fed is not likely to change its planned series of additional hikes in the short term by reacting rashly to relatively high volatility in financial markets or inevitable yield curve inversions

Figure 3. **TREASURY YIELD SPREADS** (CONSTANT MAT., DAILY DATA, BPS)

Gray shaded areas indicate US recessions as defined by the National Bureau of Economic Research (NBER).
Source: BBVA Research based on data by Haver Analytics.

Several FOMC members have recognized that recession risks have increased and that the path to a "soft landing" has narrowed considerably, but up to now, they have remained generally optimistic

Table 1. **RELEVANT REMARKS FROM FOMC VOTING MEMBERS**

Relevant remarks on the path of monetary policy
Jerome Powell (Board). Powell offered welcoming remarks at a research conference sponsored by the Federal Reserve Board on the international roles of the US dollar (see), where he reaffirmed that the Fed is "acutely" focused on returning inflation to the 2% goal. Later, he testified before the US Congress in the context of the presentation of the semiannual monetary policy report (see), where he reiterated his "unconditional" commitment to bring inflation back down to 2% and to keep long-term inflation expectations well anchored. He signaled that the Fed will quickly get the fed funds rate up to neutral and then place it at a moderately restrictive level as it keeps looking for "compelling" evidence that inflation is moving down. He admitted that a recession is not "inevitable" and that the path to achieve a soft landing is becoming more challenging, but still "plausible". He also participated in a panel discussion at the ECB Forum on Central Banking (see), where he pointed out that there are pathways to achieve a soft landing, but there's no guarantee for that. He noted that "the clock is running" and no one should assume that longer-term inflation expectations will remain anchored indefinitely. The real risk is to prevent a transition into a higher inflation regime.
John Williams (New York). During a speech delivered at the University of Puerto Rico - Mayagüez (see), Williams said that inflation is "sky-high" and the number one danger to the overall health and stability of the economy. He noted that returning inflation to 2% may take some time and may well be a "bumpy road". He expects growth to slow considerably this year. In particular, his projections are for the real GDP growth rate to be below 1.0% this year and around 1.5% in 2023, while he expects the unemployment rate to reach somewhat above 4.0% in 2023.
Michelle Bowman(Board). Noting that the current 40-year-high inflation shows little sign of moderating, Bowman gave a speech at the Massachusetts Bankers Association (see), where she said she expects an additional rate hike of 75 bps in the July meeting, and 50 bps hikes in the next subsequent meetings as long as the incoming data support them. With the current negative level of the real fed funds rate, she is committed to a policy that will bring the real fed funds rate back into positive territory. These actions do not come without (recession?) risk. She stressed that close attention is needed on the evolution of inflation expectations. If they move significantly up and high inflation becomes entrenched, it would potentially make it more difficult to get inflation under control.
Christopher Waller (Board). In a panel discussion hosted by the Dallas Society for Computational Economics (see), Waller pointed out that the Fed is "all in" on re-establishing price stability and he will support a 75 bps hike in July. Later during a speech delivered at the Rocky Mountain Economic Summit (see), he said that he expects further rate hikes after the July meeting so that policy reaches a restrictive level and stays there until there are signs of sustained reductions in inflation. He said that despite a lot of talk about recession lately and increased chances of recession, there is some expectation among FOMC participants for a soft landing, which in his view remains very "plausible" based on the optimism about the strength of the labor market and past experience showing that a reduction in vacancies can take place without a big loss of employment. He argued that with the labor market remaining very strong, the data that point to some slowing seem consistent with the pandemic-related transition from spending on goods to spending on services and that it won't damage the labor market.
Loretta Mester (Cleveland). Mester commented to the media (see, see) that it is "necessary" to bring inflation under control in order to sustain a healthy labor market. If economic conditions remain the same, she will be advocating for a 75 bps hike in July. In her opinion, inflation will be moving down, but with supply conditions remaining constrained, it will likely take a couple of years to see 2% inflation. She said she is not predicting a recession, but that it's true that the recession risks are going up. Her baseline forecast is for growth to be just a little bit below trend growth with unemployment rising over the next two years a little above 4.00 or 4.25%. During a speech delivered at the ECB (see), she said that the current situation is "very challenging", and that central banks will need to be resolute and intentional in taking actions to bring inflation down.
James Bullard (St. Louis). Bullard shared his previously delivered "The first steps toward disinflation" presentation at Barcelona (see) and Arkansas (see), where he added comments on the discrepancy between GDP and GDI; in his opinion, GDI suggests that the economy continues to grow as reflected by the strong labor markets in contrast to GDP, which is signaling a declining economy. During a panel discussion in Zurich hosted by UBS (see), he stressed the need for an aggressive response to "nip inflation in the bud before it gets entrenched in the economy". After that, Bullard commented to the media (see) that the economy is slowing, but not to a recessionary level. He also participated in a virtual discussion at the European Economics and Financial Centre (see) where he revealed to be in favor of a 75 bps hike in July, as the most recent numbers point to a "hot" inflation that continues to surprise to the upside and broaden out, and opened the door to the possibility of trying to hit a 3.75-4.00% target range by the end of this year.
Esther George (Kansas City). George offered a speech at Lake Ozark, Missouri (see). She was the only FOMC member that voted against a 75 bps hike last June, and while she supports ongoing rate hikes, she argues that the pace at which this path unfolds will need to be carefully balanced against the state of the economy and financial markets, particularly during a time of high uncertainty. With the policy rate still relatively low and a $9 trillion dollar balance sheet in the early stages of shrinking, the case for removing policy accommodation is clear-cut. However, she argued that abrupt changes can be unsettling, and that communicating the path for interest rates is likely far more consequential than its speed. She noted that a rapid pace of rate increases brings about the risk of tightening policy more quickly than the economy can adjust. Therefore, markets are volatile amid the uncertainty surrounding the outlook for the economy and the path of policy.
Susan Collins (Boston). Collins offered his first official public message (see) as president and CEO of the Fed bank of Boston. She took office on July 1, 2022, becoming the first Black woman to lead a regional Fed bank. She will vote in monetary policy decisions in the rest of the year, instead of Patrick Harker who was voting as an alternate member prior to Collins' appointment. She noted that this is a challenging time for the US economy, with inflation "too high" after employment bounced back from the deep pandemic shock.

Source: BBVA Research.

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