Fed Watch

Fed paves the way to wrap up hiking cycle in May

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The "dot plot" still points to rates peaking at 5.00-5.25% in 2023

- **The Fed delivered a dovish hike: it raised the fed funds rate by 25 bps to a 4.75-5.00% target range but struck a more dovish tone.** The unanimous decision came amid recent baking turmoil and the potential impact of tighter financial conditions as they work their way into the economy. As we argued yesterday (see), the Fed was likely to stick to its resolve to bring inflation down, but banking turmoil would weigh on the tone and the projected path for appropriate interest rates. In a sign of the importance of bank turmoil, the statement acknowledged that "recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation." The extent of these effects is uncertain, but Chair Powell added that financial conditions "seem to have tightened and probably by more than what traditional indices suggest." Importantly, Powell said in the press conference that the banking turmoil prompted the FOMC to "consider" a pause, but officials decided to hike rates again.

- **Both the wording of the statement and Powell's tone were more dovish: the "ongoing increases" in the fed funds rate was dropped and now the FOMC says that "some additional policy firming may be appropriate."** This change is significant considering that the assessment on inflation was somewhat more pessimistic: it changed from "has eased somewhat but remains elevated" to "remains elevated". The statement acknowledged the uncertainty around the effect of tighter financial conditions, and Powell said that they could be a "substitute for rate hikes." Although the extent and the duration of tighter conditions is uncertain, Powell said that they could have a significant macroeconomic effect and the Fed "will factor that into [their] policy decisions." Overall, the Fed is stressing that tighter conditions arising from the banking turmoil will take a toll on the real economy and has already changed what had been signaled a few weeks ago: a probable return to bigger hikes and a terminal rate well above the 5.1% level suggested by December's "dot plot".

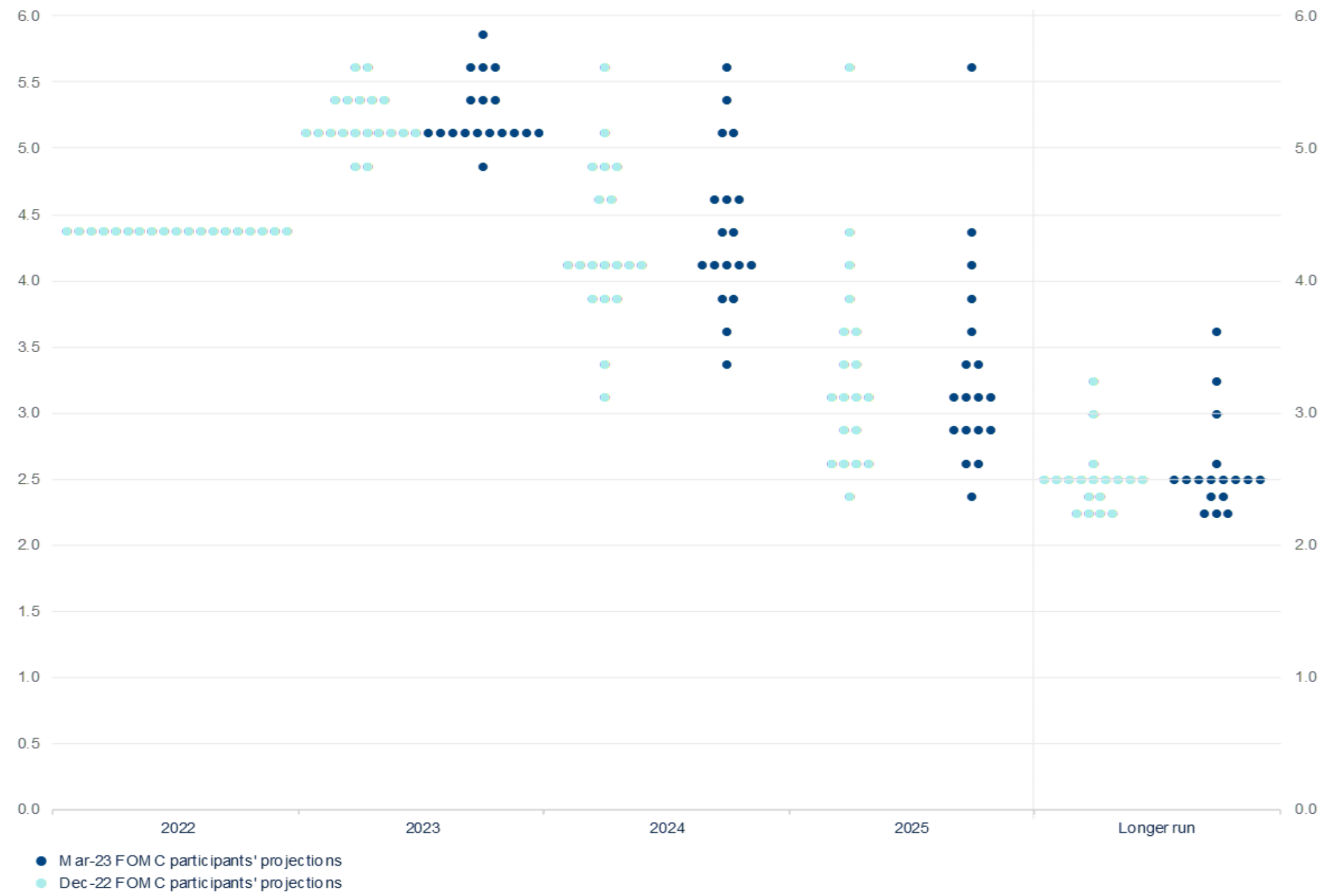
- **The updated "dot plot" forecasts just one more hike this year, with the median fed funds rate peaking at 5.1%** (Figure 1)**.** That together with the more dovish tone, tighter financial conditions, and lingering risks, points to only one more 25bp rate hike in the pipeline. Although the "dot plot" does not suggest that rate cuts are likely this year (a position that was reinforced by Powell's comments during the press conference), downside risks on growth have spiked and the Fed seems to have adopted a more flexible approach at this meeting. We think that rate cuts this year remain unlikely unless banks-related risks broaden, financial conditions tighten sharply, the economy falls into a recession soon and/or inflation eases more rapidly than currently expected. For now, we continue to expect one more 25bp rate hike to a 5.00-5.25% target range in May and a pause after that through year end. The updated SEP shows that most officials (10 out of 18) expect the fed funds rate to peak at a 5.00-5.25% range this year, in line with our baseline scenario, and to start to cut rates until 2024. The updated projections also suggest slower growth going forward and somewhat higher inflation (Table 1). Core PCE projections now anticipate 3.6% for Dec 2023 and 2.6% for Dec 2024, up 0.1 pp each from Dec's projections. GDP growth was revised slightly down (-)0.1pp for 4Q23 to 0.4% and (-)0.4pp to 1.2% for 4Q24.

The "dot plot" kept the terminal rate unchanged at 5.1% in 2023, which together with the more dovish tone, tighter financial conditions, and lingering risks, points to just one more 25bp rate hike ahead

Table 1. **FOMC PARTICIPANTS' SUMMARY OF ECONOMIC PROJECTIONS** (MARCH 2023, %)

Variable	Median				Central tendency				Range			
	2023	2024	2025	LR	2023	2024	2025	LR	2023	2024	2025	LR
Change in real GDP	0.4	1.2	1.9	1.8	0.0-0.8	1.0-1.5	1.7-2.1	1.7-2.0	-0.2-1.3	0.3-2.0	1.5-2.2	1.6-2.5
Dec-22	0.5	1.6	1.8	1.8	0.4-1.0	1.3-2.0	1.6-2.0	1.7-2.0	-0.5-1.0	0.5-2.4	1.4-2.3	1.6-2.5
Unemployment rate	4.5	4.6	4.6	4.0	4.0-4.7	4.3-4.9	4.3-4.8	3.8-4.3	3.9-4.8	4.0-5.2	3.8-4.8	3.5-4.7
Dec-22	4.6	4.6	4.5	4.0	4.4-4.7	4.3-4.8	4.0-4.7	3.8-4.3	4.0-5.3	4.0-5.0	3.8-4.8	3.5-4.8
PCE inflation	3.3	2.5	2.1	2.0	3.0-3.8	2.2-2.8	2.0-2.2	2.0	2.8-4.1	2.0-3.5	2.0-3.0	2.0
Dec-22	3.1	2.5	2.1	2.0	2.9-3.5	2.3-2.7	2.0-2.2	2.0	2.6-4.1	2.2-3.5	2.0-3.0	2.0
Core PCE inflation	3.6	2.6	2.1		3.5-3.9	2.3-2.8	2.0-2.2		3.5-4.1	2.1-3.1	2.0-3.0	
Dec-22	3.5	2.5	2.1		3.2-3.7	2.3-2.7	2.0-2.2		3.0-3.8	2.2-3.0	2.0-3.0	
Federal funds rate	5.1	4.3	3.1	2.5	5.1-5.6	3.9-5.1	2.9-3.9	2.4-2.6	4.9-5.9	3.4-5.6	2.4-5.6	2.3-3.6
Dec-22	5.1	4.1	3.1	2.5	5.1-5.4	3.9-4.9	2.6-3.9	2.3-2.5	4.9-5.6	3.1-5.6	2.4-5.6	2.3-3.3

Figure 1. **FOMC PARTICIPANTS' PROJECTED APPROPRIATE FEDERAL FUNDS RATE** (%)



Source: BBVA Research based on data by the Federal Reserve and Haver Analytics.

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