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Fed Watch

Policy rate climbs above 5%, but the Fed hints it may pause at the next meeting

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The next move is not around the corner but will likely be a rate cut

- **As widely expected, the Fed raised the fed funds rate by 25 bps to a 5.00-5.25% target range, thereby reaching the terminal rate achieved during the 2004-2007 tightening cycle.** In our opinion, the overall tone of the statement remained hawkish amid first-quarter developments in the real economy marked by "robust" job gains and still "elevated" inflation, but there was a significant change to the wording that tilts the overall tone to less hawkish: for the first time since the beginning of the tightening cycle the Fed no longer explicitly "anticipates" the need for more hikes ahead. The Fed was non-committal about pausing at the next meeting and kept its options open for upcoming decisions. The explicit forward guidance in the previous statement that "some additional policy firming" was dropped. Instead, the FOMC said that to determine whether additional firming may be appropriate it will take into account the accumulated 500bp worth of rate rises, "the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."
- **Chair Powell put a dovish spin to the still hawkish statement in the Q&A by noting that there are some initial signs that supply and demand in the labor market "are coming into better balance."** Although the statement characterizes job creation as "robust" and unemployment as "low", Chair Powell acknowledged "some softening" in labor market conditions, which are "gradually cooling" as wage increases have been moving down to a more sustained level, even after emphasizing that "wages have not been a major driver of inflation". On inflation, Chair Powell insisted that they're committed to bringing it down to 2% "over time" but signaled that the Fed will likely be patient since "it's going to take some time and it's not going to be a smooth process." Moreover, the Fed continues to expect that tighter credit conditions arising from the recent banking-sector turmoil "are likely to weigh on economic activity, hiring, and inflation." Powell added that "credit standards will be an important thing to look at" and will be factored in when assessing whether policy is sufficiently restrictive. Importantly, in the Q&A Powell emphasized the meaningful change in the statement to no longer say the FOMC anticipates more firming. All this supports the argument that further hikes ahead are less likely as monetary policy is now working in tandem with tighter credit conditions, even if its effects still "remain uncertain."
- **The Fed is now moving to a meeting-by-meeting approach as the assessment will be an "ongoing one" and future events will depend on how events play out**. With economic weakness signs building up, excess demand in the labor market coming down, a sharper drop in core inflation in store as lower rent prices feed into official data, and lower credit availability in the face of tightening lending standards, we think that the hints today represent a strong signal that the hiking cycle has ended after today's hike. Although as we expected hopes of rate cuts any time soon were dashed (see), we expect the next move to be eventually a rate cut.

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