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Fed Watch

# Fed will likely hint it will move to the sidelines following a final 25bp hike…

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## … but will dash hopes that interest rate cuts might come soon

- **The Fed will most likely deliver a final 25bp rate hike at tomorrow's FOMC meeting, taking the fed funds rate to a 5%-5.25% target range peak.** This decision will not come as a surprise. Over the past few weeks, financial markets have gradually come round to the view that there was one more hike in the pipeline in spite of recent financial-related concerns. As of today, markets' odds of a last 25bp hike stand at 85% even after yesterday's failure of First Republic Bank. Thus, the hike itself will not be a market-mover event, but the tone of the statement, prepared remarks and Q&A likely will. **All eyes will be on the overall message delivered by the FOMC and Chair Powell.** Will it remain hawkish and thus be more hawkish than anticipated by markets who seem to be expecting a significant softening in the tone?

- In a context of ongoing financial risks, still high but easing inflation, a gradual but clear labor demand slowdown, and weakening growth prospects, **we expect the Fed** to stick to its communication and take the fed funds rate above 5% (in line with the 5.1% peak shown in the latest SEP update in March) but **to soften the hawkish tone somewhat further**. Yet, we think the message delivered will remain hawkish. Although a commitment to a pause in the next few meetings is unlikely as the Fed would rather keep its options open, a hint that the Fed will move to the sidelines for the next few months is possible. For this purpose, the FOMC will likely decide to keep the message on the need of "some additional policy firming" ahead, but at the same time signal that it will remain flexible as tighter credit conditions feed into the economy and help monetary policy to lower inflation. **However,** with inflation and wage growth rates still high (Figures 1 and 2) and an economy that seems set to slow down markedly but has remained resilient up to now, **the Fed will likely dash any hopes that it will discuss cutting rates any time soon.**

- **In line with this view, several FOMC voting members continued to agree that the effects of recent banking-sector developments on credit conditions are still highly uncertain and emphasized that the Fed remains primarily focused on inflation**, supporting further policy tightening (Table 1). A few weeks ago, markets were pricing in that a rate cut cycle could start in 3Q23. They now expect the Fed to keep rates at that level for longer before starting a rate cut cycle in 4Q23, moving closer to our baseline scenario over the last month. Markets now forecast two 25bp rate cuts for the two last FOMC meetings this year in November and December. We think that **an additional repricing of market expectations is likely after the meeting** if, as we expect, the tone remains hawkish. **We continue to expect that after this final hike the Fed will pause for the remainder of the year.**

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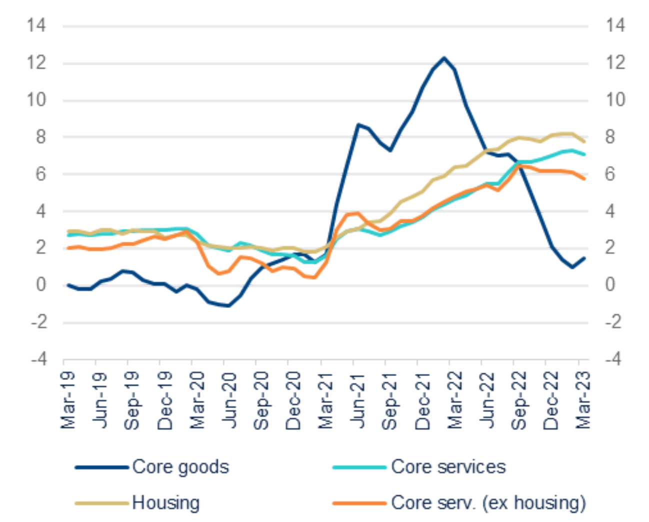
## Housing inflation is set to ease sharply as lower rent prices are in the pipeline but core services inflation ex-housing is not softening yet

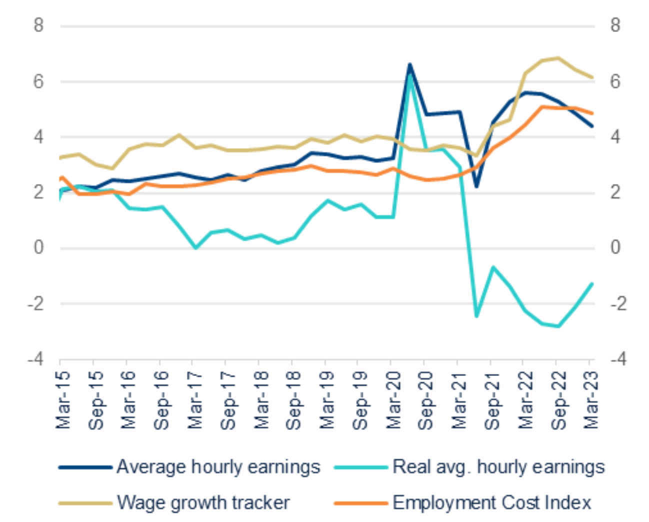
Figure 1. **SELECT COMPONENTS OF CPI INFLATION** (YoY % CHANGE)




Source: BBVA Research based on data by Haver Analytics.

## Wages are off their highs as labor market conditions are starting to ease but the ECI has remained sticky up to now

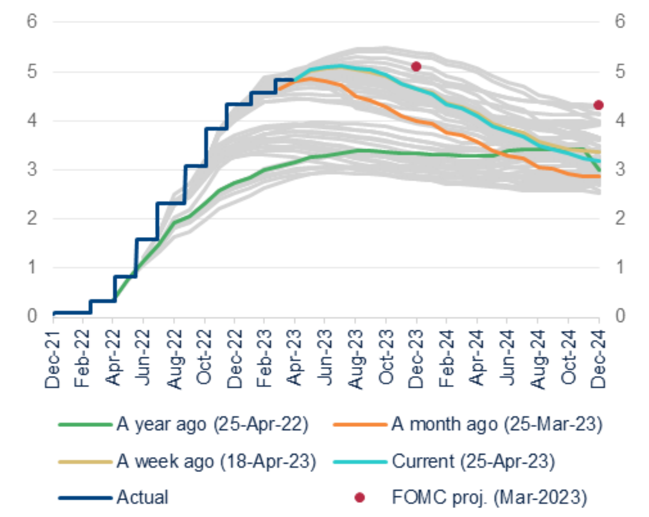
Figure 2. **SELECT WAGE GROWTH INDICATORS** (YoY % CHANGE)




Source: BBVA Research based on data by Haver Analytics.

## Markets now expect the Fed to start cutting rates in 4Q23, a significant re-pricing from last month's expectations…

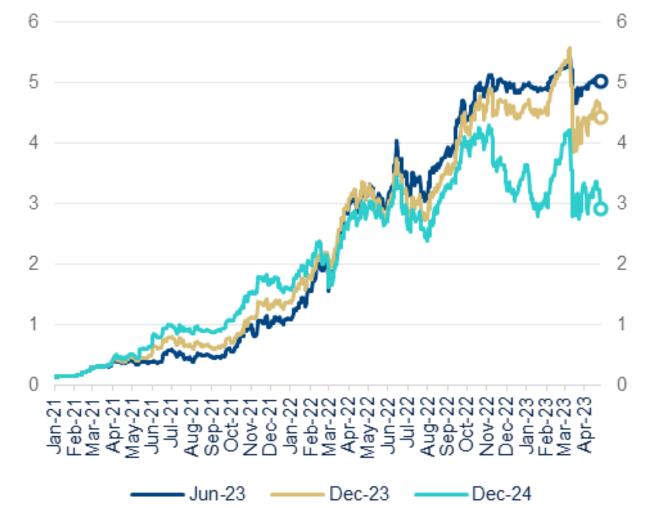
Figure 3. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)




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

## … but still price in that the fed funds rate will come down to 3.0% by year-end 2024

Figure 4. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)




Source: BBVA Research based on data by Bloomberg.

## Several FOMC voting members continued to agree that the effects of recent banking-sector developments on credit conditions are still highly uncertain and emphasized that the Fed remains primarily focused on inflation

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

| Relevant remarks on the path of monetary policy |
|---|
| **Christopher Waller (Board).** At the Graybar National Training Conference in Texas (April 14, see), Waller said that the extent of the possible effects of recent banking banking developments on economic activity, hiring and inflation are still unknown. He explained that, all else equal, a significant tightening of credit conditions could obviate the need for some additional monetary policy tightening, but making such a judgment is difficult. He pointed out that there are some encouraging signals that the labor market is rebalancing, which should help bring inflation down by reducing wage pressures. On the other hand, core inflation has not shown much improvement. In his view, monetary policy needs to be tightened further and it will need to remain tight for a substantial period of time. |
| **John Williams (New York).** At the Money Marketeers of New York University (April 19, see), Williams pointed out that recent banking-sector developments will likely lead to some tightening in credit conditions for households and businesses, but it is still too early to gauge the magnitude and duration of these effects. He said the labor market remains very tight despite some indications of gradual cooling in the demand for labor, and inflation is still well above the FOMC's longer-run goal. He expects inflation to decline to around 3.25% this year, before moving to 2% over the next two years. He anticipates real GDP to grow modestly this year before ticking up somewhat in 2024. He also projects the unemployment rate to gradually rise to 4-4.5% over the next year. |
| **Austan Goolsbee (Chicago).** At the Economic Club of Chicago (April 11, see), Goolsbee said that both current monetary policy and tighter credit conditions in response to recent banking problems can work in tandem to help cool inflation. In his opinion, even if the Fed needs to be on watch for the real possibility of tighter credit conditions as banks could pull back on lending in order to protect their balance sheets, financial dominance shouldn't drive preemptive cut rates to reduce the odds of significant financial stress. He explained that with the service sector generally being less interest rate sensitive, it might take longer to reduce inflation, though it will moderate as tighter financial conditions take the heat off the economy in general. |
| **Patrick Harker (Philadelphia).** At the Wharton School of the University of Pennsylvania (April 11, see, and April 20, see), Harker emphasized that the Fed continues to be fully committed to bringing inflation back down to 2%. He said the US economy is effectively at full employment, as job gains remain strong and the unemployment rate remains low. However, he noted that there is a lot of room for improvement on the inflation side, as recent readings show that disinflation is proceeding slowly, with only few promising signs such as cooling housing price indexes. Though he expects recent banking-sector developments will translate into tighter credit conditions for households and businesses, the full extent of these effects is still unclear, so he anticipates some additional tightening may be needed. He expects real GDP will come in a bit below 1% this year, inflation to land between 3 and 3.5% this year before falling to 2.5% in 2024, and the unemployment rate to hit around 4.4% this year. |

Source: BBVA Research.

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