Economic Analysis

The end of the Fed hiking cycle is near

El Financiero (Mexico)
Carlos Serrano
June 22th, 2023

In its most recent decision, the Fed did not change the monetary policy rate, keeping it between 5% and 5.25%. This after ten consecutive increases in the steepest cycle of increases in the last fifty years. However, both in the statement and in the projections of its members and the appearance of its president today before Congress, the Fed has made it clear that the cycle of increases has not ended. The projections mentioned above underlie two more hikes, each of 25 basis points that would take the rate to levels between 5.5% and 5.75%.

One question arises: if you are confident that more hikes will come, why pause in June only to resume in July or September? The institution mentioned that the pause was necessary to observe the effects of monetary policy on inflation so far. This is not a convincing explanation since the pause will only allow them to analyze one more piece of inflation data. It will be insufficient to determine if they have reached their desired monetary stance to bring inflation back to its target.

I think the decision is explained more by financial stability considerations. The increase in rates, together with poor supervision and poor risk management, led to the insolvency of several small and medium-sized banks, among which Silicon Valley Bank stands out. These insolvency episodes generated deposit outflows from several banks and a tightening of credit conditions. The Fed attacked these problems through liquidity facilities. Still, it seems to me that before resuming the cycle of increases, it wants to make sure that the banking system is sound and that the hikes will not cause more episodes of banking problems.

The Fed insists that more increases are necessary because, although the inflation rate has decreased considerably (from 9.1% in June 2022 to only 4% last May), it is still significantly above the 2% target; at the same time, core inflation, which offers a better measure of the medium-term trend, persists at a high 5.3%. On the other hand, the Fed thinks it is difficult for the inflation rate to decrease more markedly while the labor market continues to show high strength. And, in effect, this market is still overheated with an unemployment rate, which, although it rose in the last month, stands at 3.7%, one of the lowest levels in the previous forty years.

Based on the above, it seems to me that the Fed will raise the monetary policy rate once more in July to bring it to a range between 5.25% and 5.5%, thus reaching the terminal level of the current cycle of monetary tightening. This is because of several reasons. First, although it is true that despite having raised the rate by five percentage points, inflation is still high, we must not lose sight of the fact that monetary policy acts with lags that can be up to 18 months, with which there is still no we have seen the full effect that such increases will have on inflation. Second, today a significant percentage of inflation is explained by the high rent levels and owners' equivalent rent.

Of the four percentage points of inflation in May, 2.7 are explained by these components. Rent inflation is a lagging indicator as it incorporates contracts signed in the last year. But if we look at the rents of the most recent transactions, we see that they are already going down. Due to the above, at BBVA Research, we believe that inflation in the US will continue to decline more markedly to settle at 3.5% at the end of the year, giving the Fed the space to no longer raise it from July. However, taking inflation to 3% from there will be a relatively inertial process.

But lowering it from 3% to 2% will be very difficult if the job market remains tight. Therefore, I believe that starting in July, the Fed will keep rates at high levels for a prolonged period, eventually increasing the unemployment rate and possibly creating a recession.

BBVA Research

Creating Opportunities

DISCLAIMER

The present document does not constitute an “Investment Recommendation”, as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (“MAR”). In particular, this document does not constitute “Investment Research” nor “Marketing Material”, for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

ENQUIRIES TO:
BBVA Research: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
www.bbvaresearch.com