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Fed Watch

Fed set to skip raising the fed funds rate…

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… but will keep the door open to hike again if warranted

- **The FOMC will likely decide to “skip” raising rates, which won’t necessarily mean the end of the hiking cycle.** The inter-meeting period was marked by a significant division of opinions among Fed officials: some voting members conveyed a hawkish stance in favor of further hikes, while some others leaned toward a momentary pause in order to carefully assess the effects of both the cumulative tightening applied over the past year and the still uncertain effects of the recent banking turmoil (Table 1). Fed members were cautious to label tomorrow’s most likely movement as a “skip” rather than a “pause” so that it wasn’t interpreted as the end of the hiking cycle. Powell echoed this message by saying recently that the Fed could now make “careful assessments” after looking at the data.

- **Market expectations were increasingly pricing in the possibility of a June hike until some skip-advocating members’ comments just before the blackout period.** The futures market now assigns a 90% chance for no change in tomorrow’s decision. We agree with this view. In a backdrop of relative calm in financial markets, we think most FOMC members will favor to keep the fed funds rate target at its current 5.00-5.25% range, but also to agree on the need to signal that inflation risks continue to be skewed to the upside, signaling that a July hike is still likely. During the past month, the futures market also realigned its rate expectations with the Fed's plan of maintaining the fed funds rate at a restrictive level for an extended period of time, thus aligning with the opinion we have held for some time (Figures 1 and 2).

- **With progress in getting core inflation down still slow and the labor market still strong, we expect a hawkish forward guidance via the policy statement and the updated SEP.** The Fed will likely convey that a July hike is on the cards if warranted. Some signals point to the economy coming into a better balance, but it remains resilient. Although headline CPI inflation eased to its slowest pace in over two years in May (4.0% YoY), core prices rose 0.4% MoM, matching last month’s increase, and edged down to 5.3% YoY (Figure 3). The labor market is softening, though at a slow pace (Figure 4). A better-than-expected evolution of core inflation and/or a further loss of momentum in the labor market could change this view, but chances have been growing that strong employment and inflation data, combined with the recent favorable debt ceiling resolution, as well as a recent relative calm in financial markets after March’s banking crisis, could embolden the Fed to resume rate hikes following this month’s momentary pause. Banking turmoil effects on credit conditions will likely still be considered uncertain, as May’s SLOOS did not provide strong evidence on the isolated effects of the banking turmoil. The Fed will insist that rate cuts are not in the cards this year and a debate on the timing of the beginning of an easing cycle remains unlikely until the Fed has paused for several meetings.

- **Looking ahead, the odds of an additional hike this year seem larger than the odds of a possible start of a rate cut cycle as the Fed is still more concerned with a sticky inflation scenario than with a mild recession.** To form a wide consensus among voting members going forward will become increasingly difficult as there are already divisions within the FOMC about the appropriate path forward for monetary policy. For the time being, the Fed will buy time to allow for more data to reveal how the economy is evolving.

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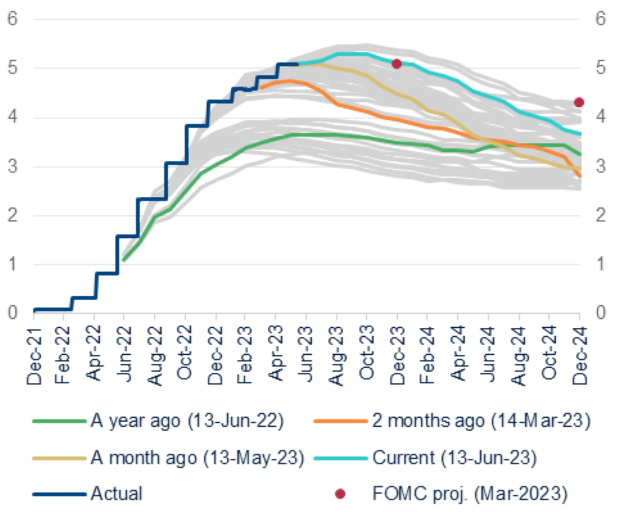
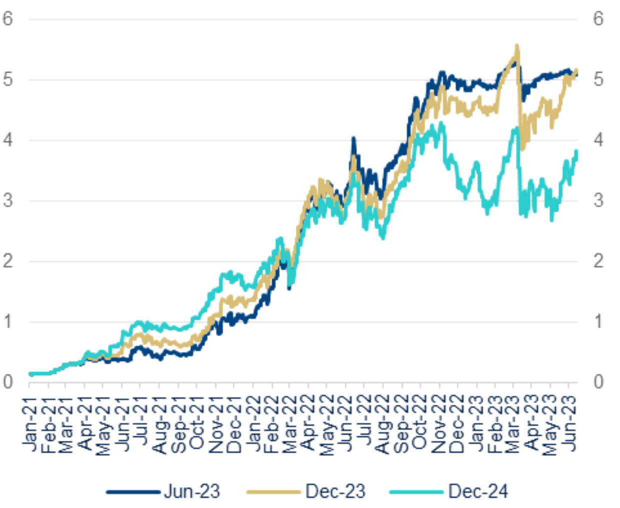
Figure 1. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



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

realigned its expectations with the Fed's plan of holding rates high for longer

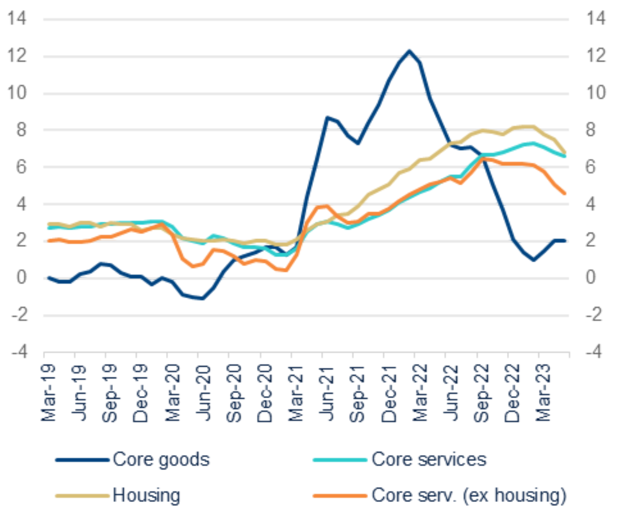
Figure 2. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



Source: BBVA Research based on data by Bloomberg.

With progress in getting core inflation down still slow and the labor market still strong, we…

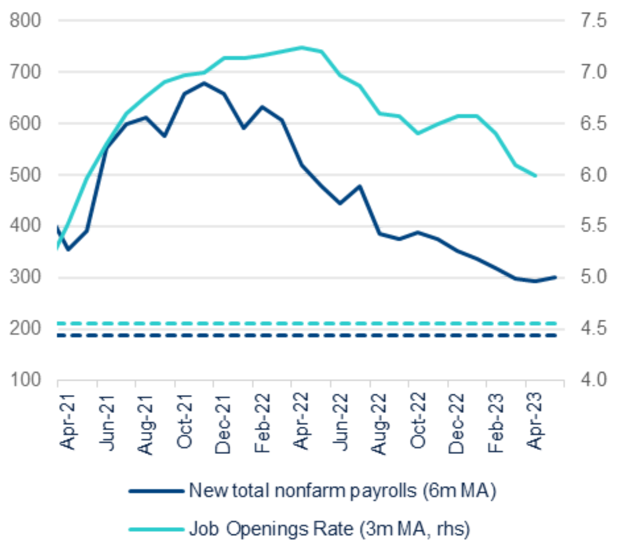
Figure 3. **SELECT COMPONENTS OF CPI INFLATION** (YoY % CHANGE)



Source: BBVA Research based on data by Haver Analytics.

… expect a hawkish forward guidance via the policy statement and the updated SEP

Figure 4. **SELECT LABOR MARKET INDICATORS** (THOUSANDS AND %)



Dashed lines indicate pre-pandemic 10-year (nonfarm payrolls, lhs) and 2-year (job openings rate, rhs) averages.
Source: BBVA Research based on data by Haver Analytics.

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The inter-meeting period was marked by a significant division of opinions among Fed officials: some conveyed a hawkish stance in favor of further hikes, while some others leaned toward a "skip" in order to carefully assess the effects of cumulative tightening and bank stress

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

Relevant remarks on the path of monetary policy
Jerome Powell (Board). At the Fed's annual Thomas Laubach Research Conference (May 19, see), he said that inflation continued to be far above target, which supports the FOMC's view that bringing inflation down will take some time, and that further policy firming could be required. He did not offer a clear signal on the path of interest rates, but noted that the recent turmoil in the banking sector will likely weigh on economic growth via tighter credit conditions. He explained that as policy has become more restrictive, the risks of doing too much versus too little are becoming more balanced.
Michelle Bowman (Board). At a symposium hosted by the European Central Bank (May 12, see), she said that the current policy stance is now restrictive, but it is uncertain whether it is sufficiently restrictive. She pointed out that the recent bank stress added to such uncertainty. She noted that the most recent CPI and employment data have not provided consistent evidence that inflation is on a downward path, which leaves the door open for additional monetary tightening. She expects the policy rate to remain sufficiently restrictive for some time to bring inflation down. At a Fed Listens Event hosted by the FRB of Boston (May 31, see), she stressed the Fed's expectation of recent months' lower rents to eventually be reflected in inflation data. However, she noted that the residential real estate market appears to be rebounding, which could have implications for the Fed's fight to lower inflation.
Philip Jefferson (Board). At a conference hosted by the Hoover Institution (May 12, see), he said that there has been little progress on core inflation: disinflation in core goods prices has slowed, core services ex-housing inflation has not shown much sign of slowing, and wage growth has continued to run ahead of the pace consistent with 2% inflation amid a still strong labor market. At a forum hosted by the National Association of Insurance Commissioners (NAIC) in Washington DC (May 18, see), he explained that while his base case forecast for the US economy is not a recession, he expects spending and GDP growth to remain quite slow over the rest of 2023, which will help to reduce job growth. He reiterated that a year is not a long enough period for demand to feel the full effect of higher interest rates, and noted that there is significant uncertainty around the amount of tightening of credit conditions in response to the bank stress, which could weigh on economic activity more than he expects. At a conference on policy challenges for the financial sector in Washington DC (May 31, see), he explained that a decision to pause rate hikes in June should not be interpreted to mean that the Fed has reached the peak rate for this cycle. Instead, it would allow the FOMC to see more data before making decisions about the extent of additional policy firming.
Christopher Waller (Board). At an economic summit hosted by the University of California (May 24, see), he noted that current economic conditions are marked by slowing activity, a tight labor market, high inflation, and higher-than-usual uncertainty about how credit conditions are evolving in response to recent bank failures. He expressed concern about the lack of progress in some important components of inflation: 1) core goods inflation, which remains well above pre-pandemic deflation; 2) housing services inflation,due to a rebound in the housing market; and 3) average hourly earnings, which are not decelerating significantly. He outlined two scenarios for the June decision: 1) skipping a hike based on the high level of uncertainty about how credit conditions are evolving, but leaning toward hiking in July based on the incoming inflation data; or 2) pausing hikes, meaning that the target range is at its terminal rate. He supports the former scenario.
John Williams (New York). At the Economic Club of New York (May 9, see), he noted that overall demand continues to exceed supply despite some signs of a gradual cooling in the demand for labor. He pointed out that inflation is still more than double the 2% longer-run goal, with core services ex-housing being the most persistent area of inflation and which will take the longest to bring down. He said he will be particularly focused on assessing the evolution of credit conditions and their effects on the outlook for growth, employment, and inflation. Particularly, he expects inflation to decline to around 3.25% this year, before returning to 2% over the next two years. He expects real GDP to grow modestly this year, and the unemployment rate to gradually rise to about 4 to 4.5% over the next year.
Austen Goolsbee (Chicago). He commented to the media (May 28, see) that the Fed has not succeeded on the inflation side, which is still too high. He noted that the actions that the Fed takes take months or even years to work their way through the system. This means that even if the Fed has raised rates by 5 pp over the last year, some part of that tightening has still to work through the system. He added that getting inflation down without starting a recession remains a goal.
Patrick Harker (Philadelphia). Harker commented to the media (May 31, see) that he was inclined to support a "skip" in interest rate hikes in June, rather than a "pause" that would mean holding rates steady for a longer period. He noted that the FOMC needs to be prepared to do more increases if inflation is not sufficiently responsive to the hikes already delivered.
Lorie Logan (Dallas). At the Texas Bankers Association (May 18, see), she said that core inflation remains too high amid the labor market's continued strength. While she recognizes the arguments against tightening monetary policy too much or too fast in a context of an unexpected deterioration of financial conditions due to the recent turmoil in the banking sector, she noted that those risks must not stop the Fed from doing what's necessary to achieve 2% inflation. She added that coming data could show that it is appropriate to skip a meeting.
Neel Kashkari (Minneapolis). At an event hosted by Northern Michigan University (May 11 see), he said that there is some evidence that inflation is coming down, but it has been very persistent, which means that the Fed is going to have to keep rates at high levels and support an inverted yield curve for an extended period of time, even if that creates real problems for banks of all sizes.

Source: BBVA Research.

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