Fed Watch

Is the Fed done raising rates?

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The door for an additional 25bp hike in September remains wide open, but a skip is likely

- **The FOMC voted unanimously to raise the fed funds rate by 25 bps to a 5.25-5.50% target range, the highest level in 22 years.** The wording of the statement was mostly unchanged, with the only change being a somewhat more upbeat assessment of the economic expansion pace, now characterized as "moderate" rather than "modest." On its own, this tweak does not change the hawkish tone, while the tightening bias wording for upcoming decisions was kept unchanged: the FOMC will assess "the extent of additional policy firming that may be appropriate." Although Chair Powell described the job growth pace as still strong, he acknowledged that the Fed is observing some softening in the labor market through fewer job openings and quits, and that consumption and investment have slowed. Yet, he downplayed the positive CPI inflation surprise in June (PCE data will be released this Friday): it was welcome but "was only one month's report." Importantly, he described monetary policy as restrictive, "more so after today's decision." Chair Powell reaffirmed his long-held belief in the potential for a narrow, yet achievable, path through which the Fed could attain a soft landing. In this regard, he revealed that "the staff now has a noticeable slowdown in growth starting later this year in the forecast, but given the resilience of the economy recently, they are no longer forecasting a recession." Regarding the recent debate about monetary policy lags, Chair Powell stated it will still take time for the "full effects" of past rate hikes to be realized, especially in core inflation. He also supported the recent optimism regarding the risks associated with March's strains in the banking sector, which in his opinion "have settled down," although they are still being carefully watched.

- **What's next for the rest of 2023? The Fed is taking a meeting-by-meeting data-dependent approach.** Chair Powell was asked repeatedly if the slower pace of tightening adopted in June after skipping raising rates implied that another skip in September was likely before deciding what to do in November. He dismissed the idea and said that **the September decision "could be another hike or remaining where we are,"** adding that **if "data suggests more hikes, that's the judgment we'll make."** This is in line with what we argued in our note yesterday (see). The Fed would remain hawkish to keep options open despite recent data pointing to cooling inflation. Keeping the door open allows the Fed to follow through with the second additional hike signaled in June's SEP if data warrants it. But the next meeting will take place in eight weeks. By then, the Fed will have two additional employment and CPI reports. We expect core inflation to soften further in July and August, and the labor market to continue to cool down. Thus, the tightening bias is not surprising and does not imply that the Fed will follow through with the second hike signaled in the most recent dot plot. Data could surprise, but our baseline scenario is that core inflation will soften enough over the next two months to persuade the Fed to skip again in September, and will likely continue to soften before the November meeting. Even if data were to be not as positive as expected, we think the bar for a hike in September is high. We thus think that, with data showing that the labor market is coming into better balance and core inflation is cooling down more markedly, **it is more likely than not that the tightening cycle has likely ended at today's 5.25-5.50% target range.**

- **The data-dependent and live-meeting approach would probably end in November, with the Fed shifting its focus to reinforce the "higher for longer" rhetoric, insisting that monetary policy has to remain restrictive enough for long enough** to bring inflation down to a path consistent with 2.0%. Chair Powell said the Fed will start to cut rates well before inflation is down to target, in line with the most recent SEP, which forecast rate cuts next year with inflation above that threshold, and explained that once inflation is convincingly on a downward trajectory towards the goal, restrictive monetary policy would no longer be necessary and the Fed could move towards a neutral stance, i.e., it could start to cut rates. We continue to think that the Fed will start a rate-cut cycle in 1H24.

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