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Fed Watch

Fed set to deliver a 25bp hike in its quest to find a sufficiently restrictive stance

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The tone will remain hawkish to keep options open despite recent data pointing to cooling inflation

- **After last month's skip, the Fed is set to raise the fed funds rate by 25 bps tomorrow, bringing it to a 5.25-5.50% target range.** The FOMC has widely signaled its intention to resume rate hikes this month, stating that holding "the target range steady" for a month would allow the Committee "to assess additional information and its implications for monetary policy." As Powell highlighted since last month's press conference, "considering how far and how fast" the Fed has moved, "it may make sense for rates to move higher but at a more moderate pace." In other words, the Fed has entered a fine-tuning stage to calibrate a sufficiently restrictive policy stance. The June SEP indicated a broad consensus among FOMC members that two additional rate hikes will be required this year. All attention will be focused on signals regarding the Fed's confidence in sticking to this plan and its approach in the following months. There are some possibilities to consider. The first is that the Fed hikes again immediately in the September meeting. We believe this is unlikely as it would mean a reversion from the current more-moderate pace approach, though not dismissible in a scenario in which inflation unexpectedly rebounds. The second option, somewhat more likely, is that the Fed decides to skip the September meeting and then deliver a last 25bp hike in November. The third, the most likely in our opinion, is that FOMC members opt to skip again in September and announce a longer pause starting in November, convinced by evidence showing that the labor market is coming into better balance and core inflation is cooling down more markedly. The tightening cycle would likely end then at the 5.25-5.50% target range. This view is the one now priced-in by financial markets (Figures 1 and 2).

- **During the intermeeting period, several FOMC voting members tried to convey that the Fed will likely have to stick to its plan of adding 50 bps of further rate tightening before year-end.** Waller and Logan were particularly vocal about this (Table 1). Logan explicitly said that "it is important for the FOMC to follow through on the signal [...] sent in June" as "both inflation and the labor market came in hotter than expected over the first half of 2023." However, recent data has generally indicated a gradually rebalancing economy. Despite an upward revision to 1Q23 consumption growth from 3.8% to 4.2%, April MoM growth was revised down to 0.2% from 0.5% and May's MoM growth was barely 0.1%. Some FOMC members emphasized recent improvements in the housing sector, but the ISM surveys continue to suggest stagnation of manufacturing activity and business investment. Inflation has also moderated. Core PCE inflation remained elevated in May at 4.6%, but was slightly down from 4.7% in April. Both headline and core CPI inflation increased a more moderate 0.2% MoM in June. Core goods inflation resumed its downward trend. Rents and owner's equivalent rents, the main drivers behind the still-high core inflation, are expected to ease significantly in 2H23 (Figure 3). There's no doubt that the labor market is still very tight, but some signs suggest it is slowly softening. Nonfarm payrolls slowed in June more than expected, while job gains for April and May were revised downwards. Both the job openings and quits rate edged down (Figure 4). The prime-age participation rate is back to its

pre-pandemic level. FOMC participants commented on this bundle of encouraging data. In general, they perceived recent data to align with the expected cooldown of the economy. However, they stressed that this dynamic should persist to be considered a “steady and clear progress” towards 2% inflation.

- **There has also been some consensus among FOMC participants regarding reduced risks associated with the effects of March’s strains in the banking sector.** The decision to skip a rate hike last month was closely related to the events in the banking sector and their uncertain effects on economic activity. The initial argument was that tightening of credit conditions from strains in the banking sector could reduce the need for some further policy tightening. So far, however, the evidence indicates that the effects of those tensions on broad financial conditions through stricter lending terms have been milder than expected. One piece of evidence comes from the fact that data on recent changes in lending conditions (as those coming from the Senior Loan Officer Survey and the H.8 release) remain in line with what banks had already been tightening before the SVB collapse. In other words, the available evidence does not support the idea that credit conditions have deteriorated significantly as a result of banking tensions alone. The optimism about this matter was particularly reflected in the comments of Waller, who said he was "more confident that the banking turmoil is not going to result in a significant problem for the economy," Logan, who noted that “banking stresses have calmed since March,” and Williams, who stated that “the situation in the banking sector really has stabilized,” so “from a risk management point of view, some of the downside risks [...] are less.” Some of that optimism is likely to be reflected in tomorrow's statement, although we consider that the message regarding this issue will continue to be the one Powell has publicly declared since March: that the effects remain uncertain. Indeed, he recently reiterated that “the bank stresses [...] may well lead to a further tightening in credit conditions.”

- **Lastly, some Fed officials have sparked a debate regarding the lags with which monetary policy is affecting economic activity and inflation in the current cycle.** While Powell has consistently emphasized that it will take time for the full effects of monetary policy to be felt, especially on inflation, some FOMC voting members, such as Waller and Logan, have expressed skepticism that the bulk of the effects from last year's policy hikes have yet to hit the economy. They argue that it is essential to consider that the current tightening cycle started several months before the Fed made its first rate hike. The pre-announced and more rapid policy rate changes, compared to the past, have likely led to a quicker adjustment in the behavior of households and firms. Consequently, they believe that the effects of the significant policy changes made last year should have impacted economic activity and inflation much faster than traditionally predicted. Thus, it is likely that a large portion of the effects of the attained restriction has already fed into the economy, which would call for further tightening to ensure a sufficiently restrictive stance has been achieved. On the other hand, Williams commented that research and evidence do not suggest any fundamental changes in the lags of monetary policy to the real economy over the last few decades.

- **To sum up, we expect tomorrow’s policy statement and Powell's comments to remain hawkish overall, acknowledging the recent positive data trends but emphasizing that “one data point does not make a trend” and stressing the need to observe sustained progress on the labor market and core services inflation.** We will look for signals that challenge or support our baseline view that tomorrow’s hike will prove to be the last in the current tightening cycle. During the Q&A session, topics related to reduced risks from March’s banking strains and the lags of monetary policy may be discussed in order to assess Powell’s opinion regarding these issues.

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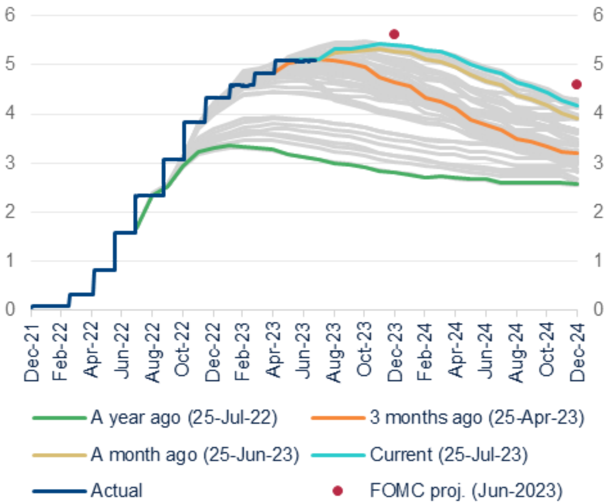
The futures market supports a view in which the FOMC skips again in Sep and announces a…

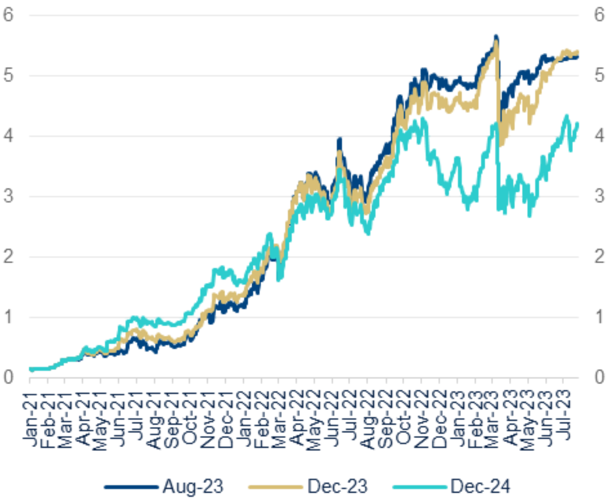
Figure 1. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



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

… longer pause starting in Nov. Data could convince the Fed to end tightening at 5.25-5.50%

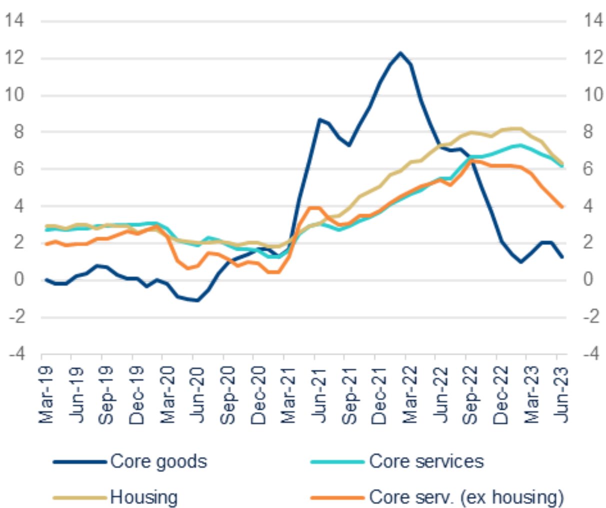
Figure 2. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



Source: BBVA Research based on data by Bloomberg.

Recent data seems to align with the expected cooldown of the economy. This dynamic should…

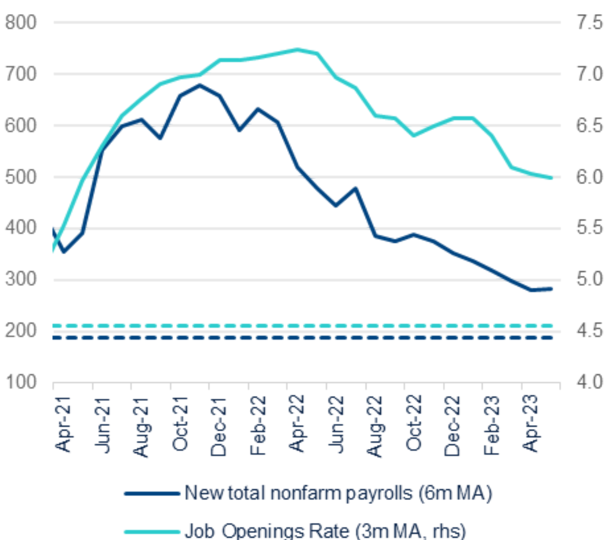
Figure 3. **SELECT COMPONENTS OF CPI INFLATION** (YoY % CHANGE)



Source: BBVA Research based on data by Haver Analytics.

… persist to be considered "steady and clear progress" towards 2% inflation

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

Relevant remarks on the path of monetary policy
Jerome Powell (Board). In his semiannual testimony before Congress (June 21-22, see), Powell pointed out that even though there are some signs that supply and demand in the labor market are coming into better balance and inflation has moderated somewhat since the middle of last year, bringing inflation back down to 2% is likely to require a period of below-trend growth and some softening of labor market conditions. He explained that it will take time for the full effects of monetary restraint to be realized, even as the economy faces tighter credit conditions from the recent strains in the banking sector, the extent of which remains uncertain. He stated that considering how far and how fast the Fed has moved, FOMC members decided last month to hold rates steady to allow them to assess additional data and its implications for monetary policy, but that nearly all FOMC participants expect it will be appropriate to raise interest rates somewhat further by the end of the year. At the ECB's forum in Sintra (June 28, see), he stressed that despite June's pause and a higher risk of doing too much, additional rate hikes were likely, and he did not rule out the option of consecutive increases rather than every other meeting. At a conference hosted by the Banco de España (June 29, see), he added that some indicators in the housing market have turned up recently and reiterated that last month's SEP showed a strong majority of FOMC participants expecting that it will be appropriate to raise rates "two or more times" by the end of the year.
Michelle Bowman (Board). At a policy summit hosted by the Federal Reserve Bank of Cleveland (June 22, see), Bowman noted that despite the significant tightening of monetary policy and the recent substantial decline of headline inflation, additional policy rate increases will be necessary to bring inflation down to target even after she supported the FOMC's decision to hold rates steady last month. She explained that although tighter monetary policy has had some effect on economic activity and inflation, core inflation has remained essentially plateau since the fall of 2022, which calls for further rate increases to achieve a sufficiently restrictive stance of monetary policy.
Lisa Cook (Board). In her renomination testimony before Congress (June 21, see), Cook said she has been supportive of the Fed's rapid and forceful actions to tighten monetary policy and bring inflation down, and that she will stay focused on inflation until the job is done.
Philip Jefferson (Board). In his nomination testimony before Congress (June 21, see), Jefferson mentioned that the economy faces multiple challenges including inflation, banking-sector stress, and geopolitical instability. He remarked that inflation has started to abate, and that he remains focused on returning it to 2% while remaining attuned to any threats of the banking sector stability.
Christopher Waller (Board). At a conference sponsored by the Norges Bank and the IMF in Oslo (June 16, see), Waller noted that recent strains in the banking sector may lead to a tightening of conditions for lending, which might reduce the need for at least some further tightening of monetary policy to lower inflation. He remarked that it is still not clear that recent strains in the banking sector materially intensified the tightening of lending conditions, because while lending conditions imposed by banks have tightened since March, the changes so far are in line with what banks have been doing since the Fed began raising rates more than a year ago. At New York University (July 13, see), Waller said he believed a 25bp hike was justified at last month's FOMC meeting as he thought credit conditions were going to tighten a lot as a result of the banking turmoil, but there was little evidence that credit conditions were tightening more than would be expected, which led him to mark up his projected path for the fed funds rate at the end of 2023 by two more 25bp hikes, with the first of those occurring in July. Joining the debate on the lags in which monetary policy operates, he argued that some economic research suggests that the effects of last year's policy tightening should hit economic activity and inflation much faster than is typically predicted, and that if one believes the bulk of the effects from last year's tightening have passed through the economy, then we can't expect much more slowing of demand and inflation from that tightening, which would call for more policy tightening ahead. He added that while economic data through early July suggest some signs of softening in the labor market as well as on core inflation, he is going to need to see this improvement sustained before he is confident that inflation has decelerated.
John Williams (New York). He commented to the media (July 10, see) that while the labor market is still clearly very strong, there are some signs of things slowing, as the overall growth in the number of hours of work being done in the economy is actually not growing that fast despite the strength of GDP growth and payroll employment. Nonetheless, he added that getting inflation to 2% will take not only getting the demand for labor further down but some increase in unemployment, which he projects will rise to 4 and 4.5% by the end of 2023 and 2024, respectively. He said he doesn't have a recession in his forecast but pretty slow growth as PCE inflation is expected to come down to around 3% and 2.5% by the end of this year and next, respectively. He said that the recent strains in the banking sector are going to weigh on the economy somewhat, though it's hard for him to know how big those additional effects are, especially because he noted that the situation in the banking sector really has stabilized. In his opinion, the US economy is not getting the full effects of the restrictive policy that the FOMC has put in place yet, as lags of monetary policy to the real economy have not fundamentally changed in the last few decades.
Austan Goolsbee (Chicago). He commented to the media (July 7, see) that based on the ongoing job growth, the Fed is on a "golden path" toward restoring price stability without a recession, even as he supports last month's FOMC indication that two more hikes are likely to come this year.
Neel Kashkari (Minneapolis). In an essay titled "The Interaction between Inflation and Financial Stability" (July 12, see), Kashkari argued that the outlook for some regional banks largely depends on what happens to inflation: if it falls as markets expect, allowing policy rates to fall, bank balance sheet pressures would likely reduce as longer-term rates fall, causing asset prices to climb. However, if inflation proves to be more entrenched than expected, policy rates might need to go higher, which could further reduce asset prices, increasing pressure on banks. In such a scenario, policymakers could be forced to choose between aggressively fighting inflation or supporting banking stability. In his opinion, one way supervisors could ensure banks are prepared for high inflation risks is to run new high-inflation stress tests to identify at-risk banks and size individual capital shortfalls.

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Lorie Logan (Dallas). At a meeting hosted by Columbia University (July 6, see), Logan said to remain very concerned about whether inflation will return to target in a sustainable and timely way. As both inflation and the labor market came in hotter than expected over the first half of 2023, she expressed the opinion that more-restrictive monetary policy will be needed, especially because she is skeptical about the potential for large additional effects from the lagged consequences of the rate increases the FOMC has already made. She pointed out it is important for the FOMC to follow through on the signal sent in June's SEP update, which showed most participants projected at least two more rate increases this year, as more than some continued very modest rebalancing is needed to have confidence that inflation will return to target on an appropriate timetable.

Source: BBVA Research.

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