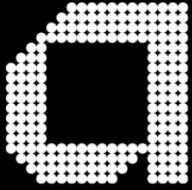

Research Institute - Insight

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#US / #Monetary policy / #Inflation

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The Fed remains committed to the separation principle, for now

The central bank delivered a dovish 25bps rate increase and the accompanying statement hinted at the need for fewer hikes, as the banking sector turmoil does some of the Fed's job. But this turbulence also increases our confidence that the US economy will likely enter a recession later this year, which we believe will see the Fed loosen policy significantly.

Key Takeaways

- As we expected, the Federal Reserve (Fed) hiked rates by 25bps to a new target range of 4.75-5%.
- The communication accompanying the decision was slightly dovish. The guidance in the statement seems to point to the need for less future hikes. And there was no increase in the expected terminal rate in the dots.
- Powell clearly acknowledged that banking sector instability will likely tighten financial conditions, albeit to an unknown degree.
- We had already taken 25bps out of our terminal rate call after the recent volatility, but will monitor incoming data closely to ascertain whether their impact on credit conditions will end up being larger. We further assess the implications of this here.
- Overall, we see recent events as further evidence that the US economy will likely enter a recession later this year. The path to a soft landing is looking increasingly narrow.
- The rapid repricing of the expected path of Fed policy in recent weeks also suggests that our expectations for significant policy loosening from the Fed could rapidly become consensus in a recession. We explore this further here.

A dovish 25bps hike

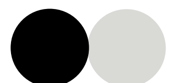
As we had expected, the FOMC increased the target range for the fed funds rate by 25bps to 4.75%-5%.

The statement removed language that guided to "ongoing increases" in interest rates, and instead noted that "some further policy firming may be appropriate". Chair Powell later clarified in his press conference that "policy firming" was intended to refer to hikes in the policy rate rather than any other policy tool. We read this as a broadly dovish shift in communication.

Indeed, the median rate dot in the Summary of Economic Projections for 2023 stayed at 5.1%, rather than moving higher, which Powell had previously suggested was likely. Overall it seems the Fed is guiding to one further rate hike from here.

Looking further forward, the median dot now shows 87.5bp of cuts in 2024 (vs. 100bp previously) and 112.5bp of cuts in 2025 (vs. 100bp previously).

The unchanged median dot came alongside slight tweaks to other economic projections with growth slower, inflation higher and a lower unemployment rate this year.



Banking sector turmoil could do some of the Fed's job

Powell acknowledged that the Committee had contemplated keeping rates on hold this meeting in light of market volatility, and the statement noted that the recent banking stress is likely to "weigh on economic activity, hiring, and inflation".

However, given the strength of activity and inflation data, the Fed is clearly keen to continue tightening monetary policy to deliver price stability, even as it has to use other tools to ensure financial stability.

We think this commitment to a separation principle between price stability and financial stability will see the Fed hike at least once more. But the principle clearly has limits. The subtext of some of Powell's remarks in the press conference seemed to be that prior to the banking sector flare-up, the economic data was pointing the Fed towards a 50bps move today.

Moreover, financial market volatility that impacts credit conditions does ultimately have important implications for spending and inflation and therefore monetary policy. So, in a sense, the tightening in credit conditions through this episode can be seen as substitute for the standard financial conditions tightening triggered by Fed hikes.

What is unclear is the extent to which this acts as a substitute. Lending standards had already begun to tighten, and estimates suggest that recent moves could be equivalent to 25-50bps worth of rate hikes.

This is why we removed 25bps from our terminal rate forecast, with a view to assess this again when we have a clearer picture on the fallout from the recent moves in markets.

Recession and ultimately policy loosening remains our base case

When asked how recent stress impacts the chance of a soft landing, Powell rather laconically commented: "it's hard for me to see how they would have helped the situation". We agree. We have increased conviction that the Fed tightening will tip the economy into recession this year.

The stress in the banking system represents a significant milestone towards recession in the sense that it will have negative spillovers on activity. It also acts as a reminder of the degree of tightening already in the pipeline and the way in which higher interest rates expose vulnerabilities in the system.

As such, we continue to expect a rapid easing cycle to commence later this year once the economy has entered recession.

Market pricing of the expected path of rates has been exceptionally erratic recently, but we think the speed at which the market moved to price in cuts following the banking system stress is suggestive of how far rates pricing will move lower once a recession commences.

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