FOMC Policy Outlook

Wednesday 27 July 2022

CAXTON

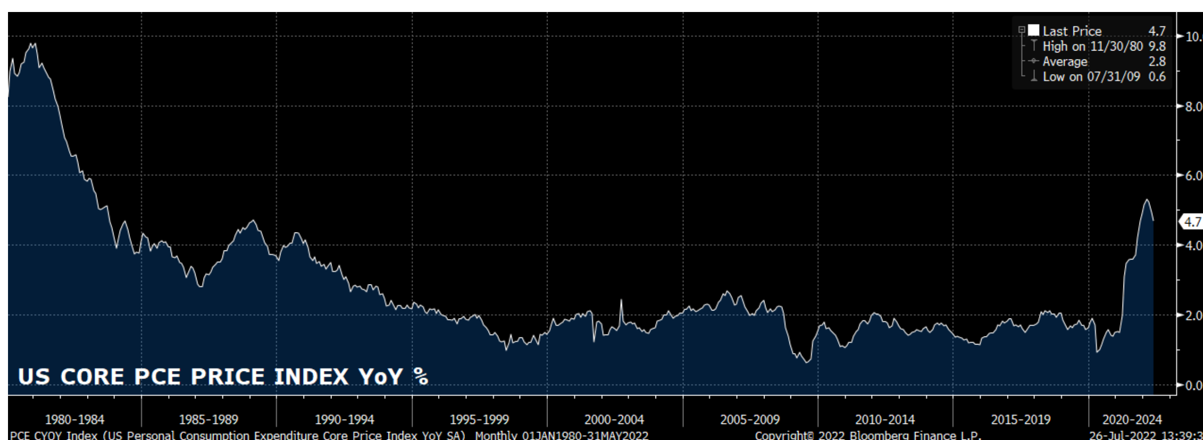
FOMC Preview – How Hawkish Will They Go?

The Federal Reserve (Fed) might be the most hawkish G10 central bank this year, as it continues to look to curb inflation to its 2% target over the medium term, by any means necessary. So far, the Fed has raised its interest rates to 1.75% level, and it will meet this Wednesday to announce further rate hikes. We expect a 75bps hike, in line with market consensus and taking the level to 2.50%, with further hikes anticipated later in the year.

A struggling economy

The Fed's quite hawkish stance at the last FOMC in mid-June, where it raised rates beyond even its own prior indications, came about from rising inflationary pressures that threatened to become persistent.

Since then, CPI has risen to a 41-year high of 9.1% YoY in June, while the Fed's most preferred measure of inflation, the PCE, remained at 6.3% YoY in May compared to the previous month. However, on the consumer front, fuel prices have started to fall in July, and energy and food commodity prices have been dropping since June, indicating a dampening of inflationary pressure is being achieved.

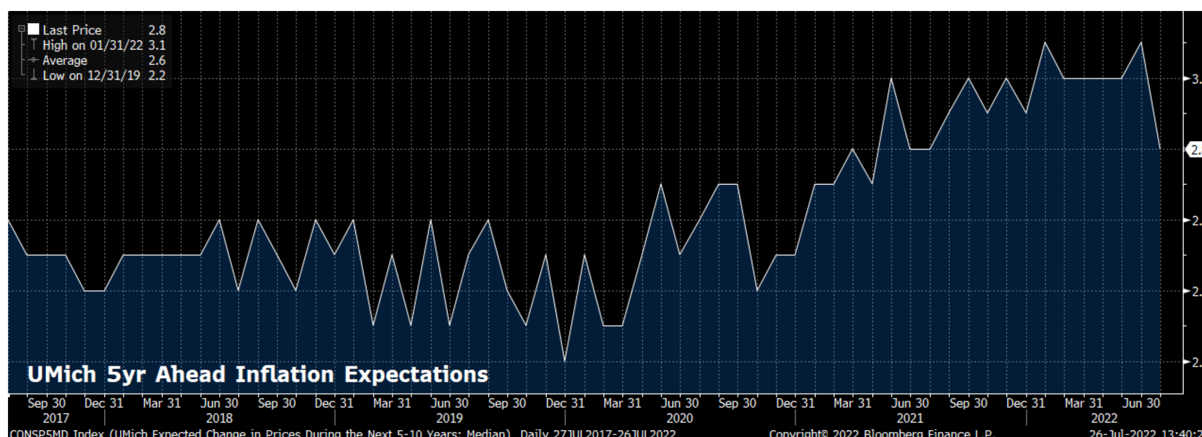


However, there remains a high level of uncertainty surrounding the US economic outlook. Indeed, last week's flash PMI for July showed an unexpected slump from 52.3 to 47.5 for the composite PMI, reaching its lowest point since May 2020 and stemming from the drop in services sector from 52.7 to 47.0, while the manufacturing sector held better, from 52.7 to 52.3. This would indicate a contraction in business activity, a slowdown in the US economy and raise concerns over a recession.

Also, in mid-July, weekly initial jobless benefit claims for unemployment rose to 251k, its highest level since November 2021, and continuing jobless claims notes that 1.384m people are receiving benefits. While these figures are rising and may evidence a labour market that is starting to cool off, it is important to note that these claims figures are well below the 1.7m continuing jobless claims in the year before the pandemic.

Consumer confidence remains relatively close to record low levels seen in June, where the University of Michigan's preliminary consumer sentiment data for July

went up from 50 to 51.1, while the SCE survey of the median 1-year ahead for consumer inflation expectations have reached a record-high 6.8% YoY. This paints a picture of consumers worried about continued inflation in the near term, which is impacting its confidence.



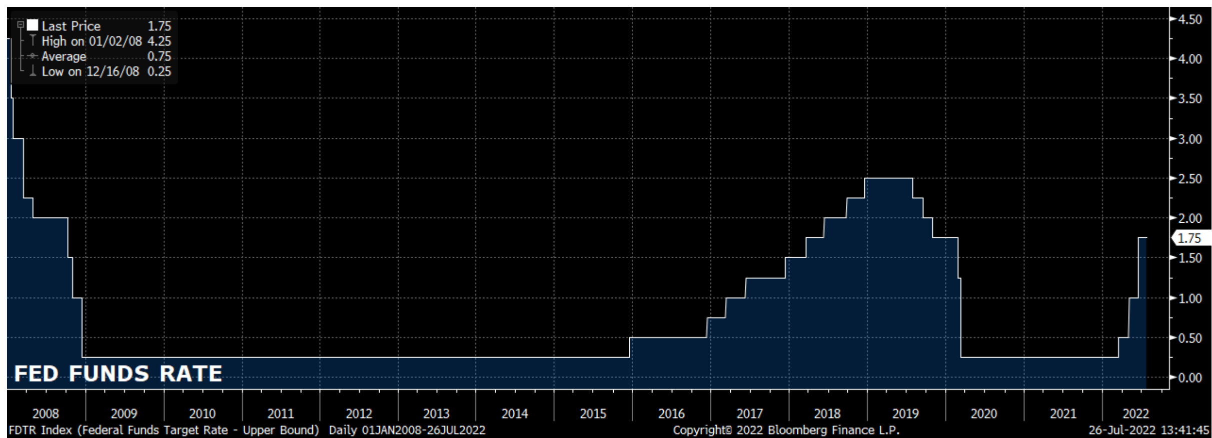
As inflation is still not decelerating, worrying consumers, and the PMI and labour market data are just starting to weaken, such economic data continues to allow the FOMC to currently remain hawkish.

A more hawkish Fed?

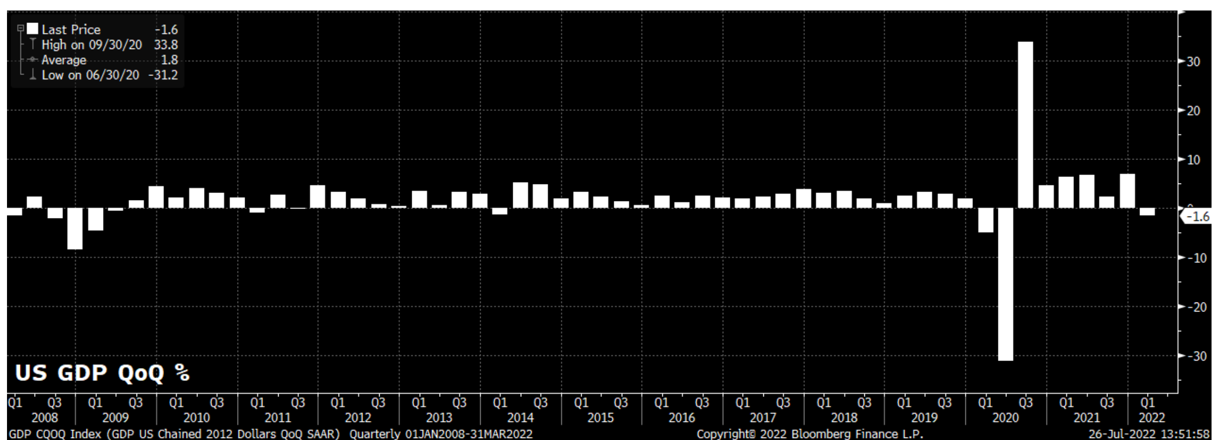
As mentioned, the FOMC will be carrying on its interest rate hikes this Wednesday, with further rate hikes expected at the next meeting in September. However, a number of G10 central banks have surprised the markets with higher-than-expected interest rates, including the Swiss National Bank, the Bank of Canada, and more recently the European Central Bank.

Despite a strong chance of a 75bps hike, one could wonder if the Fed could consider a 100bps hike instead, in order to press strongly the message that it will fight inflation by front loading the hikes, following the high CPI data in June. Keep in mind that the Fed is strongly committed to its dual mandate of price stability, meaning low inflation, and maximum employment, and has been doing so for decades.

The markets are already pricing in a 3.5% interest rate by year end, followed by a rate cut reaching about 3.28% by the first half of 2023, according to the latest Fed Funds Futures data provided by the CME. In his 15th June press conference, Chair Powell already noted that the long-term neutral rate should be around 2.5%, so a decrease in interest rates implies a significant drop in inflation, recessionary activity and a corresponding reduction in employment, or a mix of these.



Also, the Fed's growth expectations are currently at 1.7% for 2022, down from 2.8% in their March projections, as well as 1.7% for 2023, down from 2.2% in March. However, the current US real GDP growth rate, is at -1.6% for the first quarter, and according to the GDPNow from the Atlanta Fed it could also be at -1.6% for the second quarter, as of the 19th of July. This would mean that the first half of the year was a near or technical recession, but not a full recession as employment and sales were strong.



The Bottom Line

In summary, the FOMC will continue to aggressively raise rates for this month. We expect a 75bps hike for July, in line with consensus and taking the Fed's Fund Rate to 2.50%, as we believe the Fed's main focus is to see a clear decelerating trend in inflation. Going forward, the pace of any rate hikes or pivots by the Fed will be dependent on inflation data and information relevant to determining the health of employment and the US economy.

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