

Fed leaves rates unchanged in a hawkish hold

As had been well signalled, the US Fed left official interest rates unchanged at the conclusion of its policy meeting yesterday. Thus, the target range for the funds rate remains at 5.25-5.50%. The Fed has enacted 525bps worth of rate increases since it commenced tightening policy in March 2022. It increased rates by 25bps at its last meeting in July, having kept them on hold at the previous meeting in June. The decision to leave rates unchanged yesterday was unanimous.

The market's view coming in to yesterday's meeting was that rates, on balance, were at their peak. Futures contracts

were attributing only a 40% chance that there would be one further rate hike in the closing quarter of this year. Most market attention yesterday, was on the insights on the future path for rates provided by, the Fed's comments on monetary policy, the FOMC's latest dot-plot for rate projections, as well as the updated Fed macro economic forecasts.

In this regard, Fed Chair Powell continued to keep the option open of hiking again, saying "let's see how the data come in", highlighting that the Fed is very much in data dependent mode as regards future policy decisions. Most notably, the Fed's latest dot-plot of rate projections, showed the median projection of FOMC members remains for rates to be in a 5.50-5.75% range at the end of 2023. This implies one further rate increase before the year is out, with a 12-7 split on the FOMC in favour of such a hike. Even more pertinently, the Fed raised its dot-plot projections by 50bps for 2024 and 2025. The median dot-plot shows the FOMC now expects rates to be lowered to 5.1% by Q4 2024, and 3.9% at Q4 2025. The previous dot-plot in June was for rates to be cut to 4.6% by end 2024 and 3.4% at end 2025.

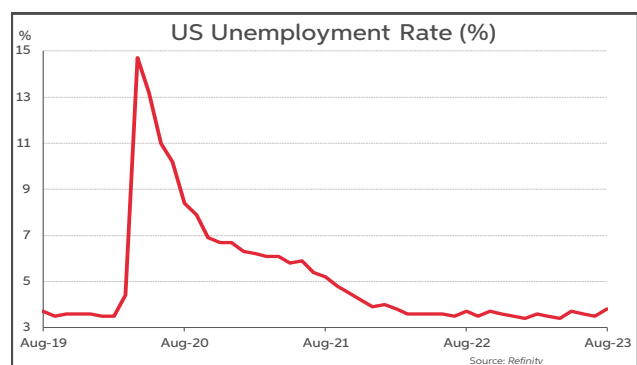
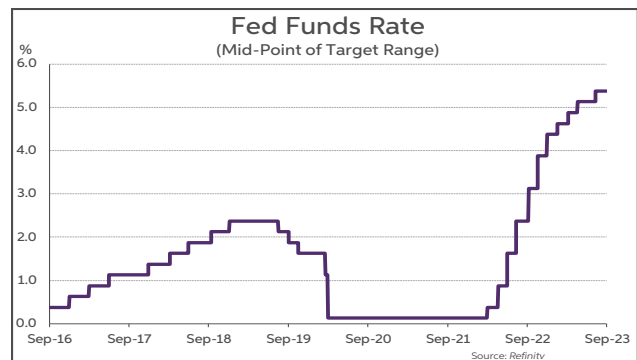
The latest set of Fed quarterly macro forecasts were also noteworthy. The projection for the core-PCE inflation rate in Q4 2023 was revised down from 3.9% in June to 3.7%. The projection for Q4 2024 was unchanged at 2.6%, but raised slightly from 2.2% to 2.3% for Q4 2025. It is seen hitting the 2% target in 2026. In terms of economic activity, the Fed upgraded its Q4 2023 GDP growth forecast sharply to 2.1% y/y from 1.0%. Growth is expected to slow to 1.5% in Q4 2024 (was 1.1% previously), before picking up to 1.8% y/y by Q4 2025. The revisions reflect that inflation has fallen more quickly than expected in 2023, while growth has been stronger than anticipated. Meanwhile, the unemployment rate forecasts were lowered from 4.1% to 3.8% for Q4 2023 and from 4.5% to 4.1% for both Q4 2024 and Q4 2025.

Overall, this represents a considerable hardening of the Fed's view on the outlook for rates since June. In fairness, though, Fed officials have been busy telling markets over the summer that interest rates would need to remain higher over the next couple of years than had been previously anticipated, in order to bring inflation back down to its 2% target. This is in the context of a continuing strong economy, with unemployment also remaining very low.

In the aftermath of the meeting, futures contracts upped the probability of a rate hike in Q4 from 40% to 60%. They also scaled back their expectations for policy easing in 2024-25. Markets now see rates being cut by 60bps from their current level by end 2024 compared to 75bps before the meeting, with rates seen declining to 4.15% by end 2025 versus 4% previously. It is worth noting, though, that this is above the Fed projection for rates at end 2025 of 3.9%.

There was quite a strong market reaction to the Fed meeting. As already noted, interest rate futures contracts hardened. Treasury yields also rose by close to 10bps, with two and ten year yields hitting 16-17 years highs of 5.2% and 4.45%, respectively at one stage. The stock market lost ground, while the dollar rose, with the euro falling back from \$1.07 to \$1.065.

Overall, this is being viewed as a hawkish hold by the Fed, with an increased likelihood of another rate hike this year and less easing next year. In particular, the Fed sees rates remaining above 5% in 2024 in the context of the economy achieving a soft landing, in line with its latest forecasts. The risks to the outlook, though, remain to the downside.



US economy performing very well so far in 2023

Having expanded by 2.0% (annualised) in Q1, GDP grew by 2.1% in Q2. Meantime, real final domestic sales rose by 2.2% in Q2, down from 4.2% in Q1. Overall, the data show that the US economy remained strong and resilient in Q2. Regarding the breakdown for Q2, consumption rose by 1.7% in the quarter (compared to 4.2% in Q1), contributing 1.1 percentage points (p.p.) to GDP. Similarly, fixed investment added 0.7 p.p. to the total. Government spending boosted growth by a further 0.6 p.p.. Meanwhile, net trade and changes in inventories clipped 0.2 p.p. from the total.

The available hard data indicate that the economy has maintained solid momentum so far in Q3. Retail sales

have increased for five months running to August, including by 0.5% and 0.6% month-on-month in July and August. The control group measure, a key core retail sales indicator, rose by 0.7% and 0.1% in the past two months also. At the same time, industrial production has rebounded strongly in Q3, having declined in May and June. Output expanded by 0.7% in July, and by 0.4% in August, leaving production 0.3% higher in year-on-year terms.

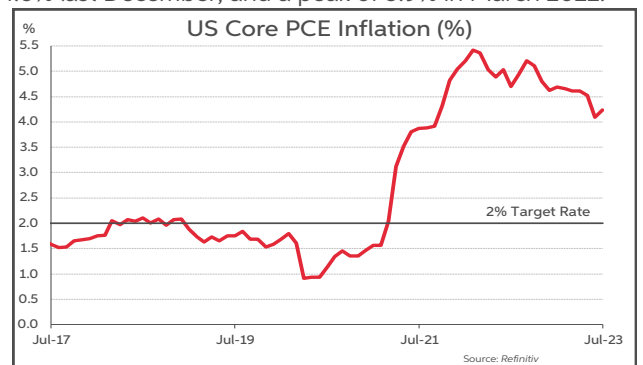
Meanwhile, survey data have been somewhat mixed to date in Q3. As has been the case for some time now, the services sector continues to outperform manufacturing. The manufacturing PMI has printed in contraction mode for nine of the past ten months. Overall, the index averaged 48.3 in Q2, and has been little changed at 49.0 and 47.9 in July and August. In contrast, the services PMI has been in expansionary territory since February, although, the pace of growth in the sector has slowed in recent months. Having averaged 54.3 in Q2, the headline services index slipped to 52.3 and 50.5, in July and August. The ISMs paint a similar picture, with the manufacturing reading below the key 50 mark for the past ten months, while the non-manufacturing ISM has been in expansion mode every month so far this year. Elsewhere, having reached their highest levels since late 2021 in July, both the Conference Board and the University of Michigan measures of consumer sentiment have moved lower recently.

The deterioration in consumer confidence is partly due to the recent sharp increase in fuel costs, and a rebound in headline inflation. Overall though, a clear disinflationary path has taken hold in the US. Headline CPI inflation jumped to 3.7% in August, up from 3.2% in July, but this is well below the peak of 9.1% registered in June 2022. The headline rate was boosted by a 10.6% jump in fuel prices in August. **Meantime, core inflation is proving sticky, but has moved lower in recent months.** Core-CPI remained in a 5.5-5.7% range in early 2023, before falling to 5.3% in May. It then declined to 4.8% in June, 4.7% in July, and to 4.3% in August. Similarly, core-PCE had been in a narrow 4.5-4.7% corridor in the six months to May, before falling to 4.1% and 4.2% in June and July. The Fed expects core-PCE inflation to move slowly towards the 2% target over the next three years, reaching 2% in Q4 2026.

In terms of the labour market, conditions remain tight, but have softened slightly. Payroll growth remained robust during the first half of the year, rising by an average of 257k per month. However, it slowed to 157k and 187k, in July and August, respectively. Meantime, the number of job openings stood at 8.8m in July, down from 11.2m at the end of 2022. Furthermore, the unemployment rate rose to 3.8% in August, its highest level since February 2022. Against this backdrop of softening, yet still tight labour market conditions, average earnings growth remains elevated, at 4.3% year-on-year in August. However, this is down from 4.8% last December, and a peak of 5.9% in March 2022.

To surmise, the US economy performed very well in H1, and has maintained good momentum so far in Q3. Furthermore, the economy appears to be relatively unscathed by the stresses which emerged in parts of the banking system this spring. However, the impact of high inflation and significant monetary policy tightening over the past year are still working their way through the economy. Overall, the Fed sees GDP growth at 2.1% y/y in Q4 2023, before easing to 1.5% y/y in Q4 2024, with growth picking up to 1.8% y/y in Q4 2025. The OECD has pencilled in GDP growth of 2.2% in 2023, slowing to 1.3% in 2024.

However, the lagged effects of monetary tightening and slower global growth mean the risks to the US economic outlook are tilted to the downside. Thus, while the economy looks on course for a soft landing, the plane is not close to touching down yet, with the Fed Chair sounding a word of caution on this yesterday.



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