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Fed leans towards further hikes

Investment event | 15 June 2023

On hold, but hawkish projections

At its June meeting, the Federal Open Market Committee (FOMC) of the US Federal Reserve (Fed) left the target range for the federal funds rate unchanged at 5.00-5.25%. The decision was in line with market expectations and comes after the Fed tightened policy at each of the previous 10 policy meetings. Chair Powell referred to there being a "unanimity" in support of the decision.

There were limited changes to the statement with the Fed again emphasising it "remains highly attentive to inflation risks". However, leaving the funds rate unchanged at this meeting "allows the Committee to assess additional information and its implications for monetary policy".

While the guidance in the statement was little changed, the Summary of Economic Projections (SEP) was more hawkish, showing an upward revision to the dot plot for the median fed funds rate in 2023 to 5.6%. This is around 0.5% higher than in the March projections, pointing to the possibility of two further 25bp rate hikes before year-end. Indeed, nine of the 18 members see this outcome as likely, with three members expecting to tighten by 75-100bp. Against this, four members see only 25bp of further tightening as likely to be necessary this year and only two see the policy rate remaining at the current level. Consistent with this bias to hike, Chair Powell confirmed July will be a "live" meeting.

Further out, the FOMC is predicting 100bp of rate cuts in 2024, taking the funds rate to 4.6% with a further decline to 3.4% during 2025. However, Chair Powell's comment that rate cuts are "a couple of years out" highlights that easing policy is not currently on the Fed's agenda.

Table 1: FOMC median economic projections

	2023	2024	2025	Longer run
GDP (% yoy)	**1.0**	**1.1**	**1.8**	**1.8**
Mar 2023 Fed projection	*0.4*	*1.2*	*1.9*	*1.8*
Unemployment rate (%)	**4.1**	**4.5**	**4.5**	**4.0**
Mar 2023 Fed projection	*4.5*	*4.6*	*4.6*	*4.0*
Core PCE inflation (%)	**3.9**	**2.6**	**2.2**	**2.0***
Mar 2023 Fed projection	*3.6*	*2.6*	*2.1*	*2.0**
Fed funds rate (%)	**5.6**	**4.6**	**3.4**	**2.5**
Mar 2023 Fed projection	*5.1*	*4.3*	*3.1*	*2.5*

*Source: US Federal Reserve, June 2023, figures refer to Q4 * Longer run figure is headline PCE inflation rather than core PCE*

The hawkish changes the Fed's policy projections reflect a stronger-than-expected start to the year for growth, leading the Fed to revise up its 2023 figure. Consistent with this, the unemployment rate has been revised down in 2023 while core inflation has been pushed up slightly. The projections for 2024 and 2025 were little changed.

Disinflation is underway

Chair Powell noted in his Q&A session that the process of disinflation in the US "would take time". He expressed confidence that goods inflation will continue to moderate in the coming months, citing a "healing" in supply chains, although it was not complete. Disinflation in services inflation was "in its early stages" according to Mr Powell, but he noted the recent decline in new rents and leases, which should ultimately lead to softer service inflation. In addition, wage growth, a key driver of underlying inflation, is showing signs of moderation amid evidence of an improving balance between the demand and supply of labour. Still, Chair Powell views the process of getting inflation down to 2% as having a "long way to go". He also stressed the committee is "unified" and will do "whatever it takes" to get US inflation down to its 2% medium-term target.

Investment Implications

We see significant downside to the Fed's policy rate expectations. Monetary policy is restrictive and its full impact is still feeding through to the economy, as are the headwinds from the banking-sector strains seen in March and April. Leading indicators of growth and employment are already deteriorating (Figure 1) and we believe the Fed will have to ease policy meaningfully from late 2023, as the economy enters a recession. The bond market's reaction to the relatively hawkish projections and Chair Powell's comments also suggests a degree of scepticism; 2y UST yields rose marginally while 10y yields fell slightly on the day, meaning the yield curve inverted further. An inverted yield curve is typically seen as an indicator of a future recession.

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The Federal Reserve left the federal funds target range unchanged at 5.00-5.25%

The FOMC's projections indicate a strong near-term bias towards further policy tightening

Our view:

We continue to argue for a defensive positioning in portfolios given a slowing economy, tightening credit conditions, restrictive monetary policy and too-optimistic consensus GDP and profit forecasts

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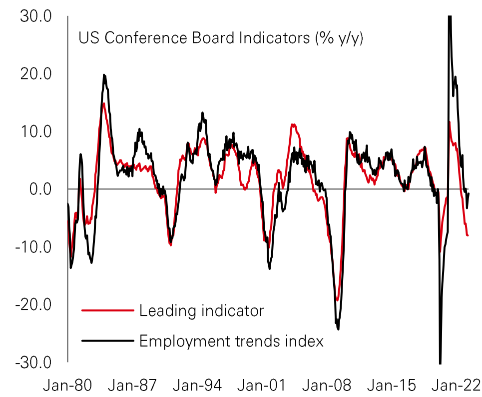
Overall, we continue to argue for a defensive positioning in portfolios. Specifically:

Figure 1: Leading indicators



Source: Macrobond, Conference Board, as of 14 June 2023

- Our central scenario is consistent with "choppy waters" for risk assets over the next 12 months, and room for downside in market prices for credits and stocks.
- Our house view is consistent with a preference for short-duration fixed income assets, especially US Treasuries, which we see performing well as recession bites. We also want to take advantage of the carry that high quality credits offer and believe solid corporate balance sheets offer protection against default risk.
- Finally, we remain positive on most EM asset classes given tailwinds from relatively low valuations, cautious investor positioning, China re-opening and a widening growth differential, the prospect of Fed cuts from late 2023 and further dollar weakness later in the year.

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