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SHORT THOUGHTS

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FOMC Preview - Hold, Skip Or Pause?

Hold Now, Hike Later? We Don't Think So

We expect the FOMC on Wednesday to hold the federal-funds target range at 5.00-5.25%. This view is broadly consistent with market pricing – the fed funds futures market has just a 28% chance of a hike at this meeting. Where we differ from consensus is that we believe we arrived at the end of the policy cycle, whereas the market is split on the chances of a hike for the July 25-26 meeting. Our view is that the economy will exhibit signs of slowing by that time, eliminating the incentive for a hike next month.

We have noted frequently that credit growth, on the heels of the banking sector stress of this past March and April, has declined significantly – and that this will eventually lead to a contraction in lending and financing, crimping business growth, hiring and activity. The chart below shows both credit standards and credit demand over the last 30 years or so. Credit conditions have tightened significantly, to near recessionary levels, while loan demand has collapsed. This is what Fed speakers refer to when they discuss “long and variable lags” in transmitting monetary policy to the real economy. In that vein, the consensus on the Committee appears to favor no hike this meeting, with not only Chair Powell at his last public appearance hinting at a “pause”, but also influential players such as New York Fed President Williams, Vice Chair-Designee Jefferson, and Philadelphia Fed President Harker (voting member this year) having endorsed not hiking rates at the June meeting.

Granted, the differences between a pause, a skip, and a hold are meaningful. Some of the

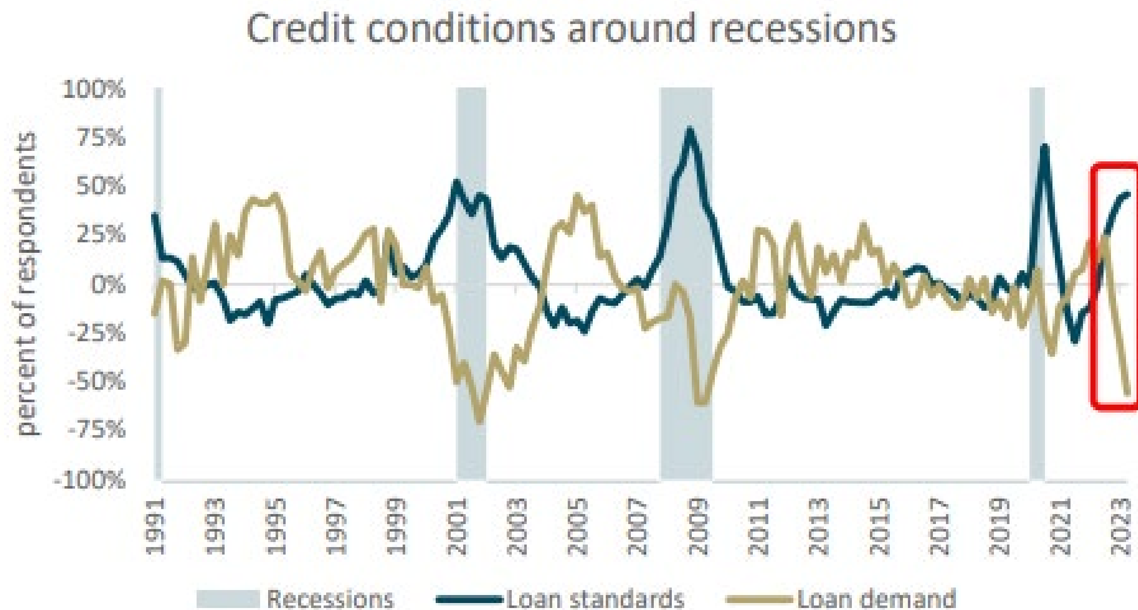
speakers cited above have couched their reluctance to raise rates tomorrow in the form of skipping a meeting, with the intention of resuming tightening in July. We think, however, that by that point an additional hike to 5.5% will be hard to pull off given what we expect to be deteriorating data on the real economy. A lot can happen between now and the end of July, but our view is that things – especially the weakening credit picture – will evolve to validate the notion that we've come to the end of the cycle. History suggests that once the Fed stops raising rates during a tightening cycle, it almost never resumes hiking at a later meeting.

As for the new Summary of Economic Projections (SEP), we expect – despite our view that the Fed is done at this point – that an additional hike will appear in the median dot for the policy rate, raising it from March's 5.1% to 5.3% or 5.4%. We also expect the forecast for the unemployment rate (currently 4.5%) to be lowered, perhaps to 4.3% or 4.2%. Even though the fed funds dot will likely be raised, we expect that (1) this won't surprise markets and instead be taken in stride, and (2) that the Fed will not be able to raise rates again this year.

Dissents are not unlikely – we think a few voting members will push for a hike, against Committee consensus. Whether that translates into one or two – or any at all – dissents is unknown. Nevertheless, even this slightly hawkish signal wouldn't faze us; policy dissents occur most often when the Fed is close to the end of a rates cycle. We wrote about the possibility of dissents in our preview of the May 2 FOMC (see here).

A final point: We acknowledge that there is some risk to our view in the form of Tuesday's CPI report for May. Should the data come in much higher than the current consensus of the 5.2% (core), then a hike could materialize. We think the odds of this are low, however.

Tight Credit Will Be This Recovery's Undoing



Source: BNY Mellon Markets, Federal Reserve Board of Governors

Dot Dissection

The SEP will be a main focus of markets, as will how any pause/skip is characterized by Chair Powell in the press conference, as well as in the meeting statement. Regarding the former, if the dots reflect an additional hike in 2023 and a lower unemployment rate, we don't think this would be market-moving, as that is likely priced in.

In sympathy with what we said above regarding the dot for the policy rate, we have little doubt that Powell will take great pains to imply that a hold on Wednesday is not the last in the cycle, but rather a "risk management " move while the Fed assesses the cumulative impact of the hiking which has taken place so far. We would expect Powell to admonish the market that a wait-and-see hold on rates on Wednesday is indeed just that, and that there is every chance that rates will rise in future meetings. That will likely be the Powell/FOMC line but as we said, we're skeptical that the Fed can and will indeed resume hikes.

We still have sympathy with the March SEP, which sees rates at 5.1% for the rest of this year and the unemployment rate rising to 4.5% by the end of the year. This scenario is closest to what we see happening. We think that the rise in the unemployment rate last month, from 3.4% to 3.7%, heralds the beginning of slowing in the labor market.

The fact that in the Fed's view – back in March, at least – 4.5% unemployment corresponds to a policy setting of 5.1% suggests that the Fed will not blink at a moderate

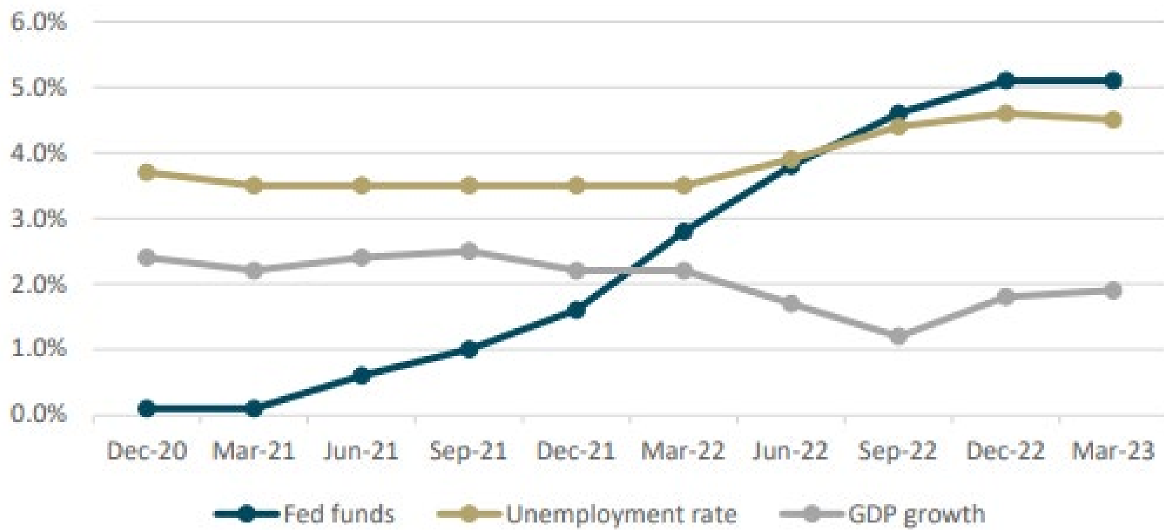
slowing of the labor force. We note that the 5.1% policy rate seen by the March SEP does not conflict with a 5.25% upper target range for the funds rate – the effective funds rate has been trading at around 5.08% for much of the period since the last FOMC.

The chart below summarizes the SEP projections for the policy and unemployment rates from every FOMC meeting since December 2020. Early in the period, through the end of 2021, the Fed's erroneous view that inflation at that time was transitory is clear. The median dot did not see the 2023 projected policy rate, while at the same time, the unemployment rate was seen as steady under 4%.

Only from March 2021 did we see more increases in the funds rate and the beginning of a slow and small increase in the unemployment rate. This implies that from that period on, the Fed saw the need for policy tightening due to stubborn inflation, slowing the economy and translating into higher unemployment. It's clear that since that time, the Fed would be quite willing to see tighter policy and a slowing economy as the price to pay for getting inflation under control. This remains our base case, and although we don't see any more hikes coming through this year, we don't see a particularly high probability that the Fed will *volte face* anytime soon, with rates holding steady through the end of the year.

A 5.2% or 5.3% dot with a slightly lower unemployment rate projection implies that the Fed thinks they have more to do, especially if they also lower the unemployment rate projections (and/or raise the GDP growth rate). It would imply that the Fed thinks the economy is still not slowing fast enough. However that may be, we reiterate our view that the economy will indeed be slowing sufficiently in the second half of 2023 and that any additional rate moves foreseen in the dots will not occur.

Evolution Of The 2023 SEP



Source: BNY Mellon Markets, Federal Reserve Board of Governors

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