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SHORT THOUGHTS

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FOMC Preview: One And Maybe Done

We expect the Fed to hike once more Wednesday, likely the last in the cycle - messaging will be key

Futures pricing is still too dovish; we don't think conditions will warrant H2 2023 cuts

Dissents in the Powell Fed have been rare - but they have happened before and may again this time

One Last Hike, But Tricky Messaging

We expect the FOMC to raise the federal-funds rate by 25bp on Wednesday, bringing the top of the target range to 5.25%. We think it very likely that this will be the final rate hike in this extraordinary policy cycle, although we're not convinced that the Fed will declare that formally. In our view, the Fed's preference to leave some ambiguity on the future course of rates stems from a still-stubborn inflation picture and a jobs market that remains somewhat tight, although showing some initial signs of loosening. Unfortunately for the Fed, the important job openings and labor turnover survey (JOLTS) data won't be available until Wednesday morning, day two of the meeting, and therefore unlikely to be of much value as an input into the rate decision. Also lacking will be April employment data, due out Friday.

Three possible signals in FOMC statement

With no Summary of Economic Projections (aka “the dots”) due this time, all attention will be on the statement and, of course, Chair Powell’s post-meeting press conference. In the last communiqué, the Fed softened its language on subsequent rate hikes by declaring “The Committee anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time.” That still left room for additional hikes but was less ambitious than references to policy actions from previous meetings, which explicitly called for “ongoing rate increases.”

We see three likely outcomes this time. The Fed could leave the March language as is, thereby signaling a good chance the Committee expects to hike again. This would be hawkish, though the conditional “may be appropriate” still leaves room to do nothing in June. Scenario two would be implying that rates are done rising for now, perhaps declaring that the current policy rate is sufficiently restrictive to eventually return inflation to the 2% target. This would be dovish, and we would expect the curve to steepen and asset markets to rally. Finally, the Fed could opt for a more “two-way statement”, stressing that rates could go either way. Typically, this would be expressed as the Fed standing ready to change policy (without implying a direction) should economic conditions change.

Core Services Inflation - Sticky And Stubborn

Source: BNY Mellon Markets, Bureau of Labor Statistics

Will Powell Push Back Against Pricing?

Obviously, stresses in the banking sector will be on the Fed's mind and we can't expect the statement to ignore them. In March, the entire reference to banking sector stresses was rather light. After insisting that the banking system is "sound and resilient", the FOMC acknowledged that "recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation. The extent of these effects is uncertain." Should the May statement feature stronger language than that, we can infer increasing concern over the economy due to recent developments – this could support market pricing for rate cuts in coming months.

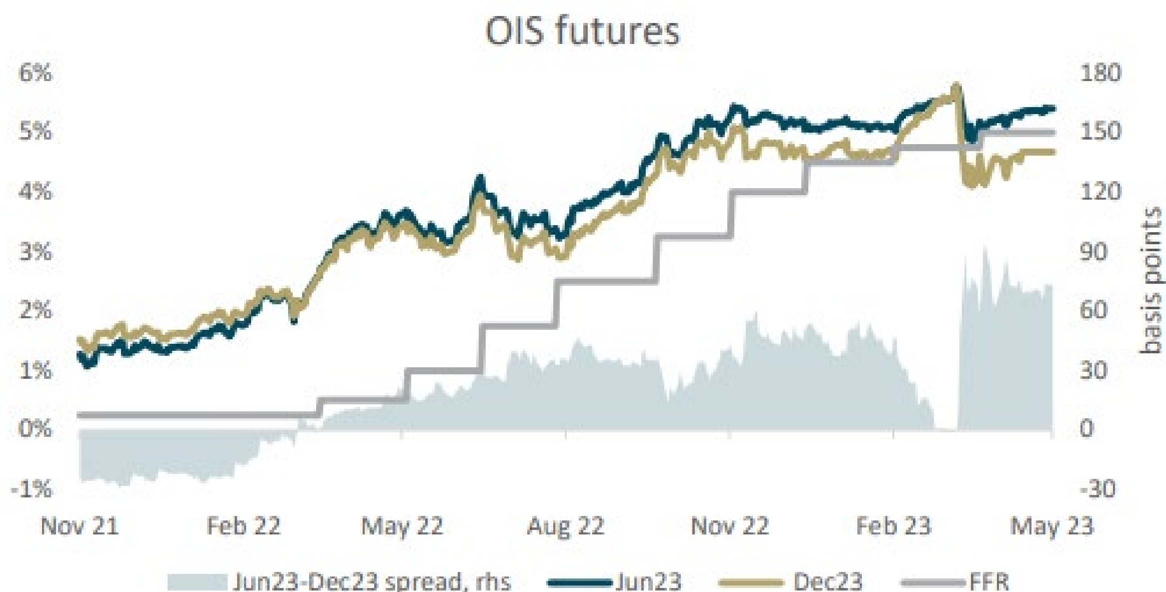
As for what the Fed might do after May, we note that uncertainty is probably very much the watchword and expect little in the way of prescriptive signaling at the press conference. However, Powell could be afforded the chance to push back against market pricing, which we still find much too dovish. The market sees around 75bp of rate cuts by January 2024, while we think the Fed will seek to keep rates above 5% for all of this year and into 2024.

Hard to see scenarios that have the Fed cutting rates by as much as market suggests

We don't think that the mild recession we see developing in the US in Q3 will be deep enough to induce the Fed to perform a *volte face* so quickly, as long as inflation remains sticky, especially in the core services sectors. For current market pricing to be validated, we would either need to see a severe recession develop relatively quickly (we don't expect this), inflation to retreat much more than expected so the Fed can pronounce its job as being finished (highly unlikely in our view), or for a mild recession to cause the Fed to blink, even with inflation still above target (also something we don't anticipate).

We would add here that the market has consistently underpriced Fed policy since the end of 2021, even before policy tightening began. The chart below shows the implied yield for the June and December 2023 option-implied swap. Note how terminal rate expectations (which we proxy with the June 2023 contract) have been well behind the curve until very recently. While the June contract currently implies a respectably high terminal rate of 5.14%, December continues to price in significant cuts.

Market Consistently Underpriced The Fed This Cycle



Source: BNY Mellon Markets, Bloomberg

Dissenting Opinions?

As alluded to above, the Committee will undoubtedly have banking-system stresses top of mind during the meeting. While these strains were offhandedly dismissed in March, we think that the passage of several more weeks and recent developments should make the Fed more circumspect in its deliberations, even if ultimately we don't think it will affect the policy decision when all is said and done.

One set of data the Committee will have on hand is the latest (and yet to be released to the public) Senior Loan Officer Survey, which assesses demand and supply of credit in the economy. FOMC members should have a good idea about the extent of credit tightening between January and April, and therefore could be more elaborate in their characterization of the economic outlook in light of what's been happening in the banking system.

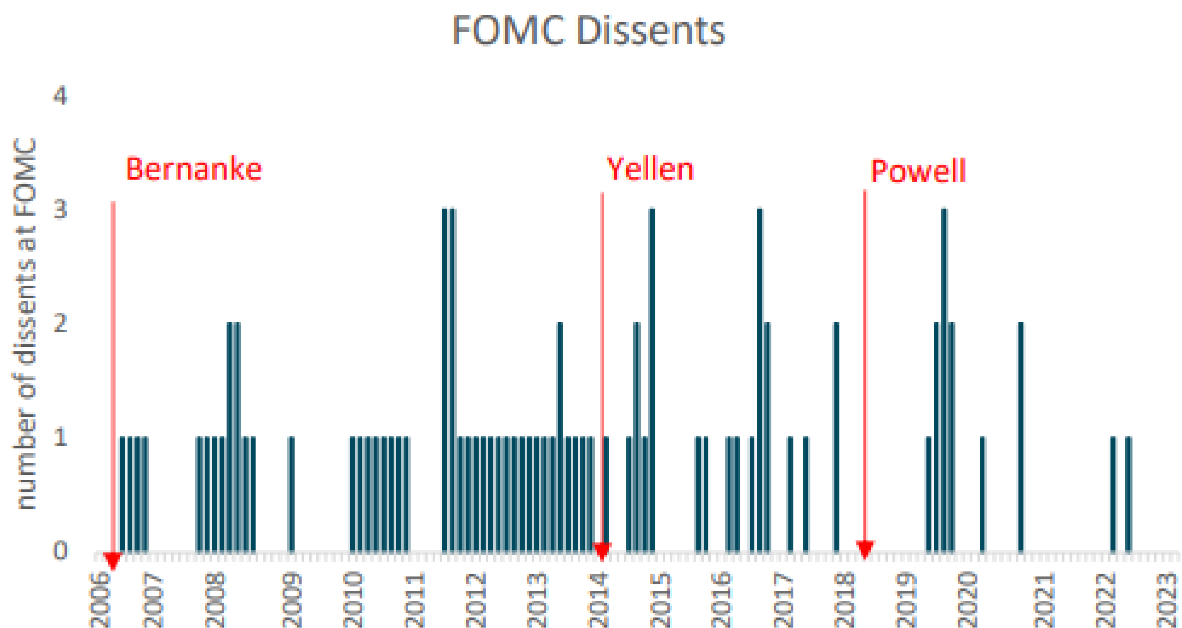
> **Dissents during the Powell era have been rare but not unprecedented**

Could there be a dissent (or two) from voting members, pushing back against a rate hike? One voting member this year, newly installed Chicago Fed President Goolsbee, has recently been less hawkish than other Fed speakers, suggesting that the central bank

needs to be mindful of the banking system issues and credit conditions.

A dissent – or even two – might make headlines, but really shouldn't. While dissents in the Powell Fed (he became Chair in March 2018) have been rarer than under his two immediate predecessors, they have occurred. Most of the dissenting votes were in late 2019, at a time of policy inflection – the Fed had finished raising rates in late 2018 and began cutting them in late 2019. There have been very few dissents since the pandemic began. Ironically, Kansas City Fed President George dissented most recently, in June 2022, voting in favor of a smaller hike than the 75bp delivered, in part due to credit concerns.

Dissenting Votes Used To Happen Much More Frequently



Source: BNY Mellon Markets, Federal Reserve Bank of St. Louis

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