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SHORT THOUGHTS

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July Hike Should End This Fed Rate Cycle

One Last Move

We expect a 25bp rate hike Wednesday from the Federal Open Market Committee (FOMC), a view shared by most market participants. We don't expect much more news or market-moving information from what we think will be a rather straightforward meeting. The irony is that this meeting will likely wind up being noteworthy in that we think – despite anticipating a fairly hawkish Chair Powell – there will be no subsequent hikes in the current cycle. The Fed, however, may not believe it's done just yet. Indeed, in keeping with officials' median expectation for a 5.6% federal-funds rate at the end of 2023, the Committee may judge that skipping in September but hiking in November would fulfill its projection.

Chair Powell has spoken recently about "speed, level, and time" as the three facets of the policy path going forward. The *speed* has certainly slowed, with rate moves going from 50bp at a clip to 25bp per clip, to skipping in June and likely hiking in July. If the same speed is to be maintained, then November would be – in the Fed's mind – the likely last hike. However, we don't think conditions then will warrant any more hikes. That means the *level* of the upper limit of the policy rate will likely settle at 5.5%. The amount of *time* it stays there is an open question. We don't expect rate cuts until well into 2024, probably no sooner than Q2.

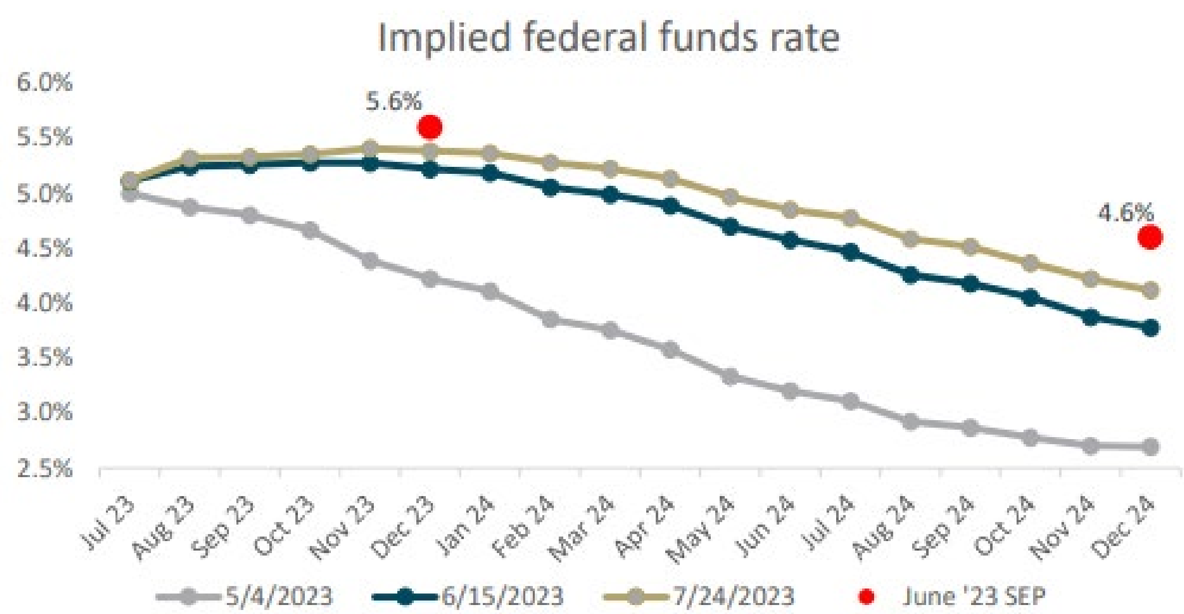
Market pricing has +25bp Wednesday nearly nailed on – a 97% chance priced into the federal-funds futures market as of this writing. As for subsequent hikes, pricing for Sept.

20 only implies a 17% chance and for Nov. 1 a 25% probability. This last fact could reflect the possibility of an “every other” cadence after July, but we note that when combined, September and November pricing only anticipates a 40% chance of a hike occurring at either meeting. The market is skeptical of that second additional hike, as are we.

We disagree with the market regarding 2024 policy and the timing and quantity of rate cuts after the peak is reached. Market-implied rates see cuts as soon as this December (see chart below) while – as stated above – we think it will be much later than that. Furthermore, even though the market has moved its rates expectations through the end of next year a tad higher, it anticipates nearly 150bp in cuts over that time horizon. This is 50bp lower than where the Fed’s June Summary of Economic Projections has end-2024 rates (4.6%).

While the Fed may currently foresee two more hikes this year, we think it'll be done Wednesday. We also see the Kansas City Fed’s annual Jackson Hole Economic Symposium at the end of August offering Powell a chance to redirect market expectations and hint that the end of the cycle was indeed reached on July 26.

Fed Pricing About Right For 2023, Too Dovish for 2024



Source: BNY Mellon Markets, Bloomberg, Federal Reserve Board of Governors

Still Skeptical On Inflation

While last month’s CPI print was encouraging in that it suggested a significant deceleration in inflation, we don't think this will be sufficient for Chair Powell to be especially sanguine on the inflation outlook. Other measures of inflation are still elevated. For example, wages in the form of average hourly earnings – which we wrote about a few weeks ago (see here) – are still well above 4% y/y, far above the approximate 3% that the Fed reckons is consistent with 2% core PCE inflation. Furthermore, the PCE price index is not behaving as favorably as CPI, and we remind readers that the Fed's inflation target refers to the former measure, not the latter. Somewhat uncooperatively for the Fed and the markets, both the employment cost index for Q2 (a quarterly comprehensive measure of labor costs) and PCE inflation for June will be released this Friday, two days after the meeting.

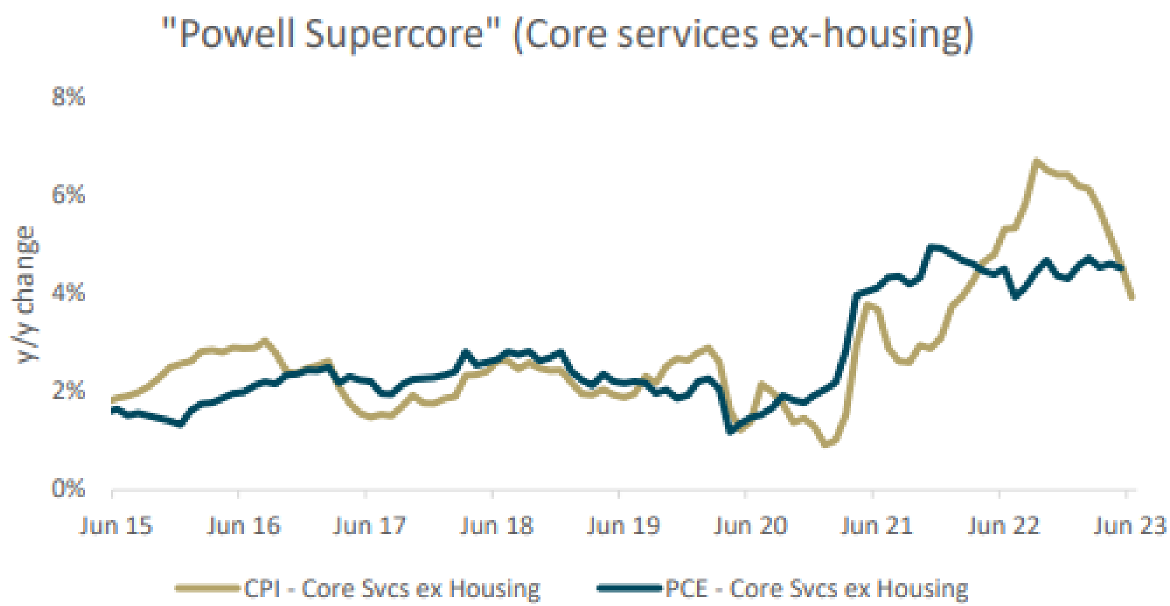
Labor Costs Need To Fall

Source: BNY Mellon Markets, Bureau of Labor Statistics

In PCE terms, core inflation in May was running at 4.6% annually. Market consensus for June is a big drop in that yearly rate to 4.2%. If accurate, that would be the biggest monthly deceleration in core PCE since the pandemic. Yet, it would still be well above the 2% that is the Fed's goal, a goal the June SEP doesn't see reached until sometime in 2025.

Expect Chair Powell to point out that the annual rate of PCE inflation for core services ex rent, a concept that is increasingly referred to as the "Powell supercore", has been averaging around 4.5% for over a year – and has not shown signs of relenting (see chart below). Powell cites this measure as being a good indicator of underlying price pressures in the services sector, and it's one that will be scrutinized when released on Friday. Furthermore, housing costs, which had stabilized in recent months, look set to inch up again, thanks to paltry supply in the market. The impact (and timing of such) this will have on the overall core PCE is still to be seen, but we still expect a general drop in inflation over the next few months to remain slow – slow enough to prevent quick rate cuts.

Supercore: PCE vs CPI Measures



Source: BNY Mellon Markets, Bureau of Labor Statistics, Bureau of Economic Analysis

Please direct questions or comments to: iFlow@BNYMellon.com

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