US Economic Update 16 June 2023

Fed pauses in June, but another hike is likely

- **The Fed paused in June but member forecasts suggest rates will likely move higher.**
- **We now expect a 25bp hike at the July meeting, taking the Fed Funds target range to 5.25-5.50%. We expect this will be the peak although risks around this forecast remain tilted to the upside.**
- **With the Fed signalling a need for more policy tightening, rates are expected to stay high for longer and we now don't see rate cuts starting until Q1 2024 (previously Q4 2023).**

Fed's June 'hawkish pause'

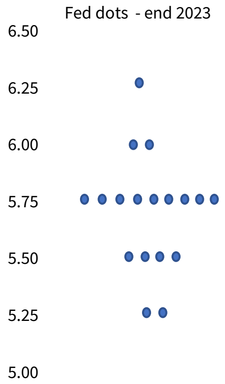
While the Fed funds rate target range was left unchanged at this week's Federal Reserve FOMC meeting, most Fed member projections indicated that further hikes will be needed. Indeed 16 out of 18 members considered a higher rate would likely be appropriate (and 12 out of 18 that this should be by 50bps or more). It is worth noting that these projections are conditional on the forecasts for inflation and other economic variables.

The median view is consistent with the fed funds rate increasing by 50bps. It is also 50bps higher than the March meeting median projection, with GDP growth over 2023 also revised higher (from 0.4 to 1.0% y/y), as was core PCE inflation (3.9% at end 2023 up from 3.6%). The projected unemployment rate at end 2023 was lowered (to 4.1% from 4.5%).

Chair Powell explained the decision to make no change to policy settings at the June meeting by noting that, as rates get closer to their final destination (i.e. peak), it makes sense to moderate the speed at which they move. This reflects the lags between policy tightening and its impact on the economy and uncertainty around what the full impact will be (and therefore how high rates should rise). Powell noted that the projections are not a committee plan but did say that the July meeting is 'live'.

While we also revised up our GDP forecasts at the end of last month, we remain more pessimistic about growth, including an expectation of a mild downturn starting in H2 2023. The Fed hiked through GDP declines in H1 2022, so the more important issue will be what happens to inflation and upstream pressure from labour market conditions. Our unemployment rate forecast for end 2023 is slightly higher, and we see a slightly lower core PCE inflation reading (but still high), than the median Fed view.

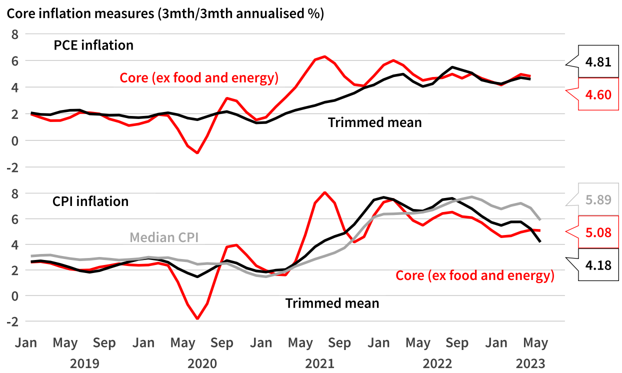
US Fed member projections (June meeting)



Source: Federal Reserve

However, there is only one more employment report, and one CPI (and PCE) inflation release, between now and the next Fed meeting. Given the clear majority view that rates need to be higher, it is more likely than not that the Fed will increase rates in July. Powell commented that they haven't seen a lot of progress over the last year in getting core inflation down. The May CPI report had another high (0.4% m/m) core reading. While there were some positive signs – particularly a low reading for core services inflation ex. rent – the Fed is looking for clear and sustained signs of a shift down in inflation, which will require a series of lower inflation readings over more than one month.

Only slow progress on getting inflation down



This is particularly so given Powell noted that risks to inflation are still weighted to the upside and that the recent history of forecasts for inflation to turn down have been wrong.

Accordingly, our forecasts now incorporate an additional 25bps increase in July (to a target range of 5.25-5.50%). If our more pessimistic view of the economy is realised, then we would expect the Fed to have reached a cyclical peak at this level.

We have also been expecting the Fed to start cutting rates at the end of the year. However, the evolution of our economic forecasts (timing of downturn pushed out, 2023 inflation forecasts revised up) have meant that the risk of a later start to cuts has been growing. Given this, and with a hike in July now expected, it is hard to see cuts starting at the end of this year. It will take time for the Fed to move from ‘more hikes may be needed’ to ‘rates are as high as they need to be’ and then onto ‘it’s time to cut’. This is particularly so given that economic data are released with a lag, and are volatile, so a run of softer data will likely be needed to see a change of view.

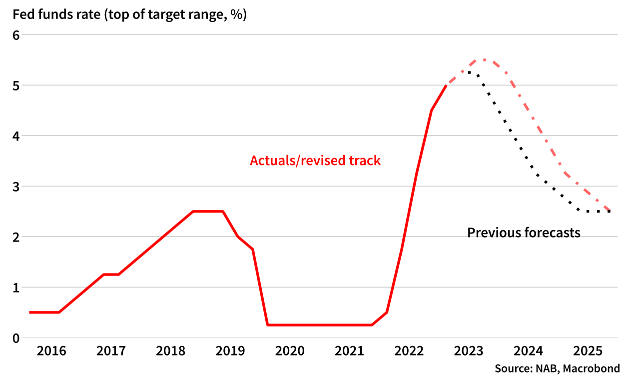
As a result, we are pushing out our expectation of when the Fed is likely to start cutting from Q4 2023 to Q1 2024 (with the March 2024 meeting pencilled in).

At the start of this process, even as rates decline, the Fed’s policy settings will remain quite restrictive (the Fed’s view of neutral is 2.5%). With unemployment expected to be clearly rising by then, and as a sustained move in inflation closer to the Fed’s target becomes evident, we see a steady series of cuts. We are allowing for a reduction in the funds rate of 25bp at each meeting to start, but for the pace to slow as (the perceived) neutral level comes closer.

This sees a lower level of the Fed funds rate than implied by the Fed member projection – 3.75% by end 2024 (top of the target range) and 2.5% by end 2025 (compared to the Fed’s median view of 4.75% and 3.5% respectively). This difference reflects our more pessimistic view of how the tightening of policy will affect the economy.

A higher peak rate, and rates generally higher over the forecast period than we previously forecast, also lead us to nudge down our growth forecasts. We expect growth of 1.3% in 2023 (unchanged), 0.6% in 2024 (was 0.7%) and 1.8% in 2025 (was 1.9%).

Fed funds rate – change to NAB forecast



Risks around Fed track

There are a range of risks around this outlook for the Fed, although they remain tilted to the upside.

A near-term risk is that the Fed goes even higher, given that the median Fed view is for two more hikes. That said, market pricing is only currently pricing in around a two-thirds probability of a rate hike in July (and an additional hike is not fully priced in this year). Downward surprises to upcoming data – particularly the next CPI (for June) and PCE inflation (for May) reports, as well as the June employment report – could see the Fed take up the option of remaining on hold again in July. At this point, if our expectations of a weaker economy/inflation start to be realised then 5.00-5.25% may end up being the peak.

Beyond a debate about whether the rates reach 5.5% or 5.75%, if inflation dynamics in the economy have changed, and there is no material reduction in inflation from its current levels, then the Fed could move rates to well above 6%. As we noted in our May report, while many measures of inflation expectations remain anchored, this is not the case with short-term measures (which in some past cycles have provided a better guide to where inflation ended up). Similarly, wages growth has also remained strong, easing only slowly to date.

That said, the likely material shift down in housing rental inflation as suggested by leading indicators, as well as continued pass through from the recovery in goods supply chains and fall in commodity prices (highlighted by the fall in the producer price inflation to below pre pandemic levels) provides a reasonable level of confidence that inflation will moderate from here. What is far less certain – and the difficulties in forecasting inflation over recent years engender a certain level of humility – is how quickly it will fall and at what level it settles at. If it falls only slowly, or inflation appears to settle at a level still well above the Fed’s 2% target, then this could also trigger a higher Fed funds rate – or rates staying high for longer.

Of course, it is possible that inflation may unwind more quickly than expected – e.g. if some prices which increased substantially during the pandemic (such as used cars) were substantially reversed. Inflation lower than we expect (particularly at or below the Fed’s target) could see rate cuts brought forward.

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U.S. economic forecasts

						Quarterly Chng %								
						2022	2023				2024			
	2021	2022	2023	2024	2025	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household consumption	8.3	2.7	1.9	0.8	1.7	0.3	0.9	0.4	-0.1	0.1	0.2	0.3	0.3	0.4
Private fixed investment	7.4	-0.2	-1.8	0.4	3.7	-1.0	-0.1	0.1	-0.4	-0.5	0.0	0.5	0.7	0.9
Government spending	0.6	-0.6	2.6	0.6	0.8	0.9	1.3	0.2	0.1	0.1	0.1	0.2	0.2	0.2
Inventories*	0.2	0.7	-0.6	0.0	0.1	0.5	-0.6	0.1	-0.1	-0.1	0.1	0.0	0.0	0.0
Net exports*	-1.7	-0.6	0.4	-0.1	-0.1	0.2	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**5.9**	**2.1**	**1.3**	**0.6**	**1.8**	**0.6**	**0.3**	**0.3**	**-0.2**	**-0.1**	**0.2**	**0.3**	**0.4**	**0.4**
Note: GDP (annualised rate)						*2.6*	*1.3*	*1.1*	*-0.8*	*-0.2*	*0.7*	*1.3*	*1.5*	*1.7*
US Other Key Indicators														
PCE deflator-headline														
Headline	5.7	5.7	3.5	2.2	2.0	0.9	1.0	1.0	0.9	0.6	0.6	0.4	0.6	0.6
Core	**4.7**	**4.8**	**3.7**	**2.2**	**2.1**	**1.1**	**1.2**	**1.0**	**0.8**	**0.6**	**0.6**	**0.5**	**0.5**	**0.6**
Unemployment rate - qtly average (%)	**4.2**	**3.6**	**4.2**	**4.9**	**4.9**	**3.6**	**3.5**	**3.6**	**3.8**	**4.2**	**4.4**	**4.7**	**4.8**	**4.9**
US Key Interest Rates														
Fed funds rate (top of target range)	**0.25**	**4.50**	**5.50**	**3.75**	**2.50**	**4.50**	**5.00**	**5.25**	**5.50**	**5.50**	**5.25**	**4.75**	**4.25**	**3.75**

Source: NAB Group Economics

*Contribution to real GDP growth

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