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FOMC July Meeting Reaction: Fed shifts to wait-and-see approach

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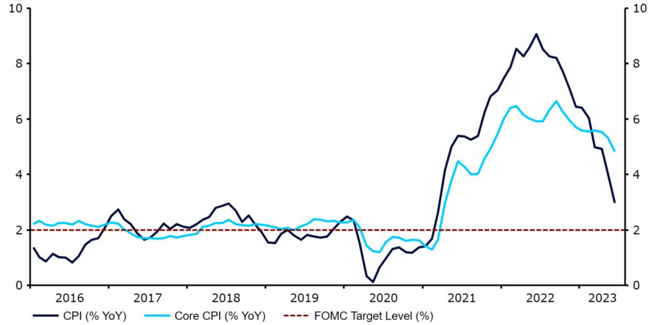
Fed shifts to wait-and-see approach

The July FOMC announcement went according to the script, with the Fed delivering a 25 basis point hike, while refraining to commit to future policy moves.

In a unanimous vote, the Federal Reserve raised rates to a range between 5.25-5.50% on Wednesday, in line with still elevated US inflation and a strong labour market. The statement was largely unchanged from the June meeting, although interestingly the assessment of economic activity was upgraded. The Fed now expects 'moderate' expansion of the US economy this year, from the 'modest' growth anticipated at the previous meeting. Indeed, the committee has now forsaken its call for a US recession in the medium-term, which runs through 2025, which we see as a rather noteworthy optimistic turn.

On the inflation outlook, chair Powell noted that progress had been made towards achieving the 2% target, although there remains a 'long way to go'. He also said that conditions were not yet in place for a sustained return to 2%, suggesting that the Fed is waiting for a greater moderation in economic activity, and a further loosening in the labour market, before expressing confidence on the inflation outlook. Powell welcomed the June CPI miss, which had triggered the largest weekly sell-off in the US dollar since November, yet he was clearly not getting too carried away, saying that this was 'only one report'.

Figure 1: US Inflation Rate (2016 - 2023)



Source: Refinitiv Datastream Date: 27/07/2023

While the Fed's upgraded economic appraisal can perhaps be viewed as an argument in favour of additional rate hikes, Powell neither committed, nor fully closed the door, to further tightening, as we had anticipated. During his press conference, Powell noted that it was 'possible' the Fed could raise rates again at its next meeting in September, although he also stressed that the same was true for no change. Indeed, he explicitly said that the current environment is not one where the Fed would want to provide 'a lot of forward guidance'. This effectively shifts the committee towards a data dependent approach, and one that provides rate-setters with a degree of flexibility as to future policy moves.

We see this entirely wait-and-see approach as the appropriate stance in the current environment. While we have seen encouraging progress on inflation, committee members can take stock as they await further evidence of a moderation in prices, and an easing in economic activity, before either delivering another rate increase, or calling time on the hiking cycle. It will be nearly two full months before the next FOMC meeting in September, by which time members will have received both the July and August CPI reports, and the PCE inflation data for July. This may be enough evidence for the Fed to provide a clearer indication as to their upcoming policy plans at the next meeting.

Financial markets reacted in a relatively subdued fashion to Wednesday's announcement. We did see a modest sell-off in the US dollar, although the scale of the move lower was relatively contained, with the USD index shedding no more than around one-third of a percent in the immediate aftermath of the decision. We think that this reaction can be partly ascribed to Powell's comments on interest rate cuts. He strongly pushed back against market pricing for lower rates in the first quarter of 2024, definitively saying that the Fed would make a judgement on cuts a 'full year' from now. In other words, the Fed is currently not anticipating rate cuts until the July 2024 meeting, at the earliest. This is a mismatch relative to futures, which are continuing to price in the first cut in March 2024.

Figure 2: US Dollar Index (1 week)

Source: Refinitiv Datastream Date: 27/07/2023

Wednesday's FOMC announcement has not changed our view on either Fed policy, or the US dollar. We believe that the July hike will transpire to be the last, with the Fed to pause for at least the next handful of meetings, before it begins cutting rates at some point in mid-2024. Futures are continuing to price in around a 40% chance of another hike by November, although the reaction in markets suggests that most investors believe the cycle to be over. It remains to be seen whether the FOMC will explicitly end the hiking cycle in September. We suspect that it won't, although it may at least hint that it is done raising rates. At any rate, we think that the Fed will both end the hiking cycle, and deliver the first cut, sooner than most of its major peers. This should exert downward pressure on the dollar in the medium-term, and supports our view for a broadly weaker greenback over our forecast horizon.

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