

MARKET COMMENTARY

A less aggressive Fed signals that its job is not done yet

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- **The FOMC members voted unanimously for a 25bps rate rise, as expected. The discussion on policy shifted from the speed of monetary tightening to its extent: the peak rate is near and two further 25bps increases remain the base case.**
- **Disinflation has started driven mostly by goods. Shelter will follow, in line with the moderation in house prices increase, but a significant part of core services inflation shows no signs of abating. Lowering it requires bringing back into balance a still too hot labour market.**
- **The Fed, though, is confident that this need not entail a sharp rise in unemployment nor a recession. Therefore, the FOMC is neither considering a pause in rate hikes nor expects to cut this year. The recent loosening in financial condition is not yet a cause for concern, as it must be weighed against the sharp tightening of the past year.**

As expected, the Fed shifted to 25bps rate rises, but was very careful to signal that monetary tightening is not finished. The press release was little changed from December but acknowledged the easing of inflation that allows the FOMC to focus on the extent of the further tightening, rather than its pace. Broadly this means that the FOMC thinks that the view expressed in the December projections does not change: two more rate hikes are therefore appropriate.

In the press conference, chair Powell reiterated that the economy is slowing but the full effect of the past sharp rate increase has yet to be felt in full. For 2023, his base case remains that of a further slowdown not turning however into recession. The strong fiscal capability of state and local governments and public investment in the pipeline were cited as important factors behind this rather rosy view. We expect GDP to contract slightly in the central quarter of the year. The labour market remains “out of balance”, with today’s data release showing 1.9 available jobs for every unemployed in December. Wage growth is moderating but still too high to foresee a rapid decline in inflation.

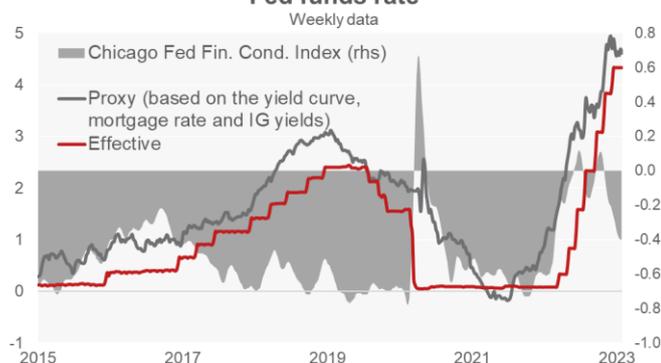
Powell welcomed the tentative signs of easing inflation but warned that this is at an early stage and repeatedly stressed the need to distinguish across sectors. Starting with goods, the expected easing of bottlenecks and consumers’ tilt toward services is triggering the climbdown the FOMC was expected, but Powell cautioned that goods inflation could bounce back in mid-year. Core services inflation is still inching up: the acceleration in the shelter component is not cause for concern as it reflects the past increase in house prices, which are now cooling. Shelter inflation will go down over the coming months. What worries FOMC the most is the rest of core service inflation (56% of the index) which is still increasing strongly: Powell reminded that it is a very diverse basket of categories, only a few of which respond to labour market. Long term inflation expectations remain anchored and short-term ones have moderated, but this provides no ground for complacency. The longer inflation stays high the higher the risk that it becomes entrenched in wage demand, possibly triggering the wage-price spiral that currently does not show up in the data.

Therefore, monetary policy will have to tighten further, but the FOMC slowed down its pace to better assess the need for future actions. A pause in rate tightening (just like what the Bank of Canada has just announced) was not discussed. Powell reiterated that the risk of doing too little now - and being forced to tighten hastily afterwards- is difficult to manage. The Fed has no desire to overtighten but should this happen it can be unwound quickly. If the economy proceeded in line with the December economic projections it will not be appropriate to start cutting this year. However, in our view a sharp deterioration of the economy would warrant some easing in the final meeting of the year. A dovish tilt in the composition of the voting panel (according to our preliminary analysis) could help in this sense.

The FOMC is not particularly worried by the recent loosening in financial conditions: what matters is the upward trend seen over the past year, and anyway financial conditions are only one factor influencing policy. But the strong pushback against rate cuts this year is clearly meant to prevent a loosening in financial conditions which would undo part of the job the Fed has done so far.

On the debt ceiling, Powell sounded confident that the Congress will find a way to raise it. However, in case of a breach he warned that the Fed has limited scope to protect the economy. And the financial system

Fed funds rate



Source: Refinitiv, GIAM

FOMC voting members

	Dovish				Hawkish	
Governors	Barr	Brainard Cook	Powell Jefferson	Bowman Waller		
NY Fed president			Williams			
2022 Voters			Collins (Boston)	George (Kansas C.)	Bullard (St. Louis)	Mester (Clev.)
2023 Voters			Harker (Phil.) Logan (Dallas)	Goolsbee (Chicago)	Kashkari (Minn.)	
2024 Voters			Daly (S.F.)	Bostic (Atlanta)	Mester (Clev.) Barkin (Richmond)	

Variable	Prev. FOMC meeting	Latest	Chg.
Real Activity			
Weekly activity index (yoy GDP)	0.7	0.7	0.0
ISM - Manuf	49.0	48.4	-0.6
ISM - Services	55.5	49.2	-6.3
Macro Surprises	9.9	-6.1	-16.0
Labor Market			
Payroll growth (3 mth. MA)	263	263	0
Unemp. Rate	3.6	3.5	-0.1
Unemp. Rate (broad)	6.7	6.5	-0.2
Hourly wages, % yoy (3 m. MA)	5.6	5.3	-0.3
Prices			
Core CPI	6.0	5.7	-0.3
Core PCE	4.7	4.4	-0.3
Trimmed PCE	4.7	4.6	-0.1
U. Mich 5 yr exp.	2.9	2.9	0.0
NY Fed 3 Y exp.	3.0	3.0	0.0
5Y5Y fwd exp.	2.1	2.2	0.1
Financial Conditions			
Chicago Fed index*	-0.2	-0.4	-0.2
10 yr. Treasury	3.5	3.5	0.0
- Risk neutral Component	4.3	4.2	-0.1
- Term Premium	-0.8	-0.7	0.1
Yield curve (10Y - 3m)	-0.8	-1.2	-0.3
S&P 500	3995	4077	2.0%
Trade Wighted Dollar	130.0	126.8	-2.5%
WTI Crude Oil	77.2	78.9	2.2%
* Decrease: looser conditions			

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