

MARKET COMMENTARY

Fed's hawkishness is peaking: Takeaways from the July meeting

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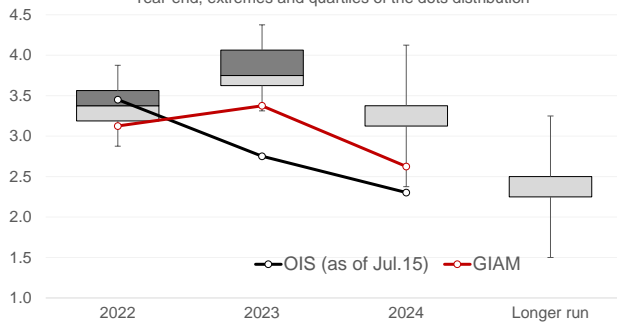
- The expected 75 bps rise came with hints that the steepest part of policy normalisation has probably ended. Chair Powell remained deliberately vague about the September meeting, but hinted that a smaller 50 bps increase is possible. This is indeed our expectation.
- Going forward, the FOMC points to the fact that June's "dots" remain the relevant guidepost. They show the policy rate peaking at 3.8% and no easing before 2024, contrary to market expectations. Given our below consensus growth forecast, which entail an almost 50% probability of recession in 2024, we project a lower (3.4%) peak rate, reached in Q1 2023 .
- With low oil prices contributing to moderating inflation expectations and some signs of cooling in activity and employment growth, inflation is no longer the only focus for the FOMC. While acknowledging the slow-down in activity, it dismissed fears of an impending recession, and still showed high conviction that it can be avoided.

Despite the unanimous decision on another 75 bps hike, the July meeting delivered a rather dovish message. Here are the key points:

- The policy rate has reached what the Fed estimated to be the neutral range (2.4% to 2.5%). While Chair Powell deemed that some more tightening is needed, the steepest part of normalisation should be over. Powell did not provide any strong guidance, on the next move: "unusual" 75 bps hikes may still be required, but after last night our confidence in a less aggressive 50 bps move in September has increased.
- For the longer term Powell signalled that the rate path indicated in June remains relevant, as it carries two messages: first rate rises will continue, second, and more important, the market pricing of rate cuts already in 2023 is too extreme. Given our below consensus growth forecast (2023 growth well below 1% and a [nearly 50% probability of recession](#) in H1), we stick to our view of a somehow lower peak in rates but do not expect cuts before 2024.
- Upside risks to inflation remain relevant, as the core rate remains strong and it will take time for the expected softening in house prices to feed through the large shelter component of CPI. Still, the drop in oil prices is moderating both market-based expectations and surveys. The FOMC reiterated that it needs strong evidence of slower price increase. It expects a weakening of activity, especially in the more rate sensitive parts of the economy, like construction. Together with tentative progress towards a more balanced labour market this increases the likelihood of a slow, but steady moderation in inflation going forward. Still we see the core rate at well above 4% by year end.
- This will allow the Fed to loosen the focus on inflation and concentrate more on activity. Powell dismissed the fears that the US economy will be soon in recession, pointing to several signs of strength, first and foremost the labour market. Still, employment is a lagging indicator, and the weakness in consumer confidence is actually leading to slower consumption. Moreover, the full impact of the past tightening in financial conditions has yet to show up in hard numbers on activity, another reason for the Fed to shift to a lower gear to assess the evolution of the economy. Powell reiterated that the FOMC is very keen to avoid a recession, and that is feasible.
- The balance sheet reduction is proceeding on autopilot, no news. The FOMC expects it to continue for another 2- 2 ½ years.

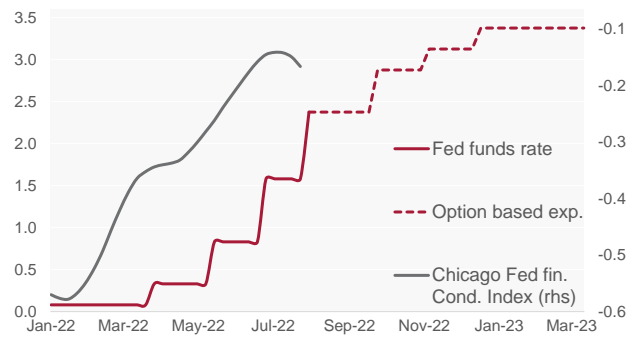
Distribution of the June FOMC "dots" and Market expectations

Year-end, extremes and quartiles of the dots distribution



Source: Federal Reserve Board, Datastream, GIAM estimates

Fed funds rate path and financial conditions



Source: Federal Reserve, Chicago Fed, CME, GIAM

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