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TRENDMACRO LIVE!

On the May FOMC

Wednesday, May 3, 2023
Donald Luskin

Powell affirms this was the last hike. First cut when inflation falls (which it already has).

Today's hike of 25 bp in the fed funds rate target was precisely at expectations. And the language changes in today's FOMC statement versus last month's – were precisely what canonical Fed-watcher and Powell-whisperer Nick Timiraos foreshadowed in his *Wall Street Journal* article yesterday. Right or wrong, Timiraos's FOMC preview articles reliably tell you what the market expects – so no surprises here:

> "~~The Committee anticipates that some~~In determining the extent to which additional policy firming may be appropriate ~~in order to attain a stance of monetary policy that is sufficiently restrictive~~ to return inflation to 2 percent over time~~. In determining the extent of future increases in the target range~~, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."

To be perfectly clear, this language moves, critically, from "The Committee anticipates…some policy firming" to saying "policy firming may be appropriate."

Generative AI token: "The last Fed rate hike, style of fantasy art"

Source: DreamStudio running SDFX Beta

Update to strategic view

FEDERAL RESERVE, US MACRO: As expected in markets, the funds rate was hiked to 5-1/8%. The statement language eliminated the phrase that "the committee anticipates further policy tightening." In the presser, Powell affirmed that this means a pause. The statement said, and Powell reiterated that the banking system is "sound and resilient," but he also that that improvements in regulation are necessary to make it sound and resilient. Powell said the timing of the first rate cut will be contingent on seeing inflation tangibly fall. He gave some, but only weak, acknowledgement that inflation is already falling – many components to levels already below the Fed's target. After the meeting, markets now assign a small probability to the first cut coming as soon as June, with virtual certainty that there will be four 25 bp cuts by January.

[Strategy dashboard]

This is virtually identical to the language change employed in 2006 between the May 10 and June 29 meetings of the Bernanke Fed, when another large hiking cycle was paused.

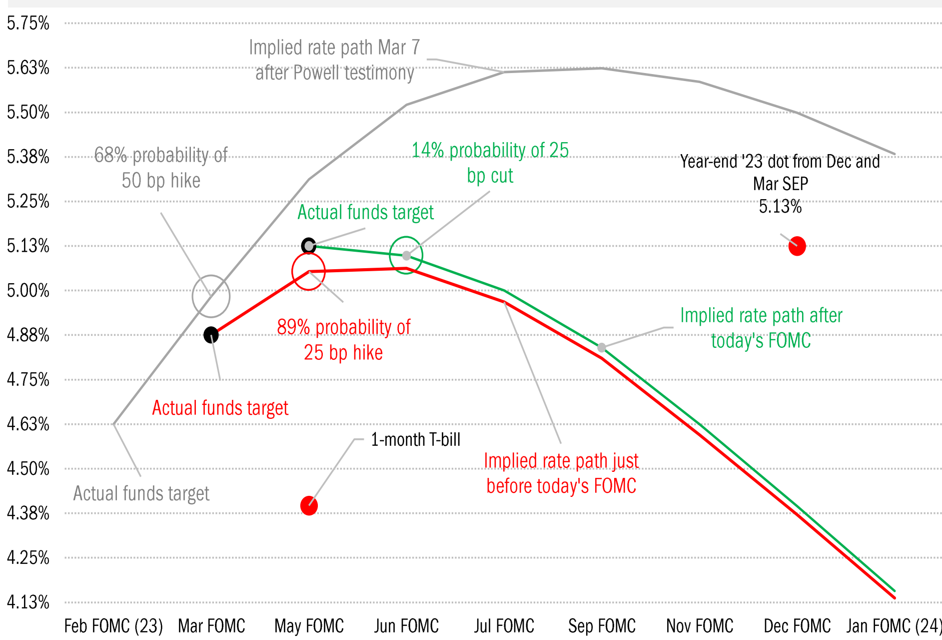
In the first paragraph of the prepared remarks that began post-meeting presser, Chair Jerome Powell reiterated that "the U.S banking system is sound and resilient." At the end of the same paragraph, he confessed that "we need to address our rules and supervisory practices to make for a stronger and more resilient banking system." *So we're not sure, based on his testimony, whether the banking system is sound and resilient or whether we need to take steps to make it sound and resilient.*

But here's what's important… In the very first question in the post-meeting presser, Chair Jerome Powell was asked, "Should we read today's statement that the committee is prepared to pause?" Powell gave the best possible answer other than simply saying yes. *He said, "A decision on a pause was not taken today," but then went on to point out, just as we just did, that the "Committee anticipates…some policy firming" had been excised.*

So now the line of scrimmage shifts away from the question of what the peak rate in this cycle will be – we know that, now: it is 5-1/8%. Now the big question is how long will that peak last.

- Just before the FOMC today, the money-market curve implied that the new high funds rate would persist for the June FOMC meeting at least (please see the chart below). Then there is a growing implied probability of rate cuts gets built in, with some probability

Futures-implied funds rate, by FOMC meeting



Source: Bloomberg, TrendMacro calculations

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assigned as soon as the July meeting. By the January FOMC, the funds rate is expected to be 4-1/8%, implying 100 bp of rate cuts, cumulatively, distributed evenly throughout the period.

- As of this writing, with the presser just concluding, _*the curve shows a small probability of a cut as soon as June*_. _*That's new*_. But overall the shape and terminal point of the curve didn't change much (again please see the chart on the previous page).
- _*This continues to seem to us like a sensible outlook.*_
- In the presser, Powell didn't directly address the question of the duration of the plateau before the first cut. He did say that today's new funds rate was perfectly consonant with the median "dot plot" at 5-/18% in the March Summary of Economic Projections (see "Data Insights: Federal Reserve" May 3, 2023). But that "dot plot" was a projection for year end. On the one hand, Powell's saying that confirms that this was the last hike. To be sure, on the other hand, it could also be interpreted as hinting today's new rate will last till year-end. We think the latter is over-thinking it.
- The reality is that it will depend on data. The way Powell wants to frame it, that data is all inflation data. In reality there are a lot of other factors that will make up the Fed's mind, but in response to a question about the timing of possible rate cuts, Powell was emphatic that it could *only* happen in the face of sharply falling inflation. He was silent on the fact that goods inflation is already below the Fed's target on a year-on-year basis, and services inflation has fallen to near-target on a three-month basis (see: "FOMC Preview: Inflation (and First Republic) Collapse" May 1, 2023).
- He did say that "supply and demand in the labor market is coming into balance." And he did say that "inflation has moderated somewhat." Never mind that he also claimed, believe it or not, that he has never said previously that rapid wage growth leads to inflation. We'll work on a new video, a gag-reel really, to fact-check that one…
- _*But every bit of that is splitting hairs. The important thing is that this was the last rate hike. This we know.*_

Bottom line

As expected in markets, the funds rate was hiked to 5-1/8%. The statement language eliminated the phrase that "the committee anticipates further policy tightening." In the presser, Powell affirmed that this means a pause. The statement said, and Powell reiterated that the banking system is "sound and resilient," but he also that that improvements in regulation are necessary to make it sound and resilient. Powell said the timing of the first rate cut will be contingent on seeing inflation tangibly fall. He gave some, but only weak, acknowledgement that inflation is already falling – many components to levels already below the Fed's target. After the meeting, markets now assign a small probability to the first cut coming as soon as June, with virtual certainty that there will be four 25 bp cuts by January.