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Fed announcement: on the fence

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As widely expected, the Fed opted to hike by a quarter point to bring the ceiling on the fed funds range up to 5.50%. The statement was somewhat hawkish given that it didn't soften the language around job gains as being robust or inflation as being elevated, despite the cooling in those monthly indicators recently. Economic activity was also seen as firmer, expanding at a moderate pace, rather than the modest pace cited in the prior statement. Moreover, the statement still referenced that the Committee would be determining the extent of additional policy firming, with no mention of a pause. In line with that, we still see the Fed hiking by 25bps in September to reach terminal, with the labor market still tight, and policymakers' bias towards doing too much rather than too little to fight inflation.

Although the statement implied that another hike didn't seem to be a question of if, but rather when for the Fed, Powell expressed less certainty about the need for further tightening in his press conference. He gave some insight into the data dependent approach that policymakers are taking when looking at the need to hike further or pause, with each meeting viewed as being live. While the cooling in CPI was viewed as favorable, Powell mentioned the need to see more sustained evidence of a cooling, and policymakers will be looking for the labor market in particular to come into better balance. Although the start of a balancing is in evidence, with participation in the core working-age group increasing, job vacancies declining, and wage growth having slowed, demand for workers still exceeds supply.

Powell seemed confident the impact of past rate hikes was in the pipeline, stating that the real fed funds rate is now in positive territory, and above the longer-term neutral rate. He highlighted that consumer spending is slowing, and that the interest-sensitive areas of housing and investment are showing the impact of past rate hikes, but it will take time for the full effects to be realized on inflation, and his view is still that the economy will avoid a recession, as the economic backdrop heading into this rate hike was healthier than expected months ago.

Bond yields rose slightly following the statement, but fell sharply during Powell's press conference as he was decidedly unsure that the economy would require higher interest rates ahead, and markets are priced for only roughly 10bps of hikes from here. We still think that a September hike is probable, with job gains likely to remain above the roughly 100K pace that Powell has cited is consistent with a labor market that isn't tightening further. But if, as we expect, job gains and inflation signals continue to cool thereafter, the September hike could prove to be the last for this cycle, with the first easing not likely until Q2 2024, as we'll also need time for inflation pressures to sufficiently abate.

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