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Fed lays the groundwork for further tightening

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The FOMC opted to exercise patience and skipped an interest rate increase at today's announcement, but laid the groundwork for 50bps of hikes ahead. That's in line with our view that we will see a 25bp rate increase at each of the next two meetings to reach a terminal rate of 5.75% on the ceiling of the fed funds range. With markets only anticipating the addition of one quarter-point hike to the median projection, 2yr bond yields rose sharply on the announcement, but fell during Powell's press conference. The higher terminal rate in 2023 implies a steeper path for rate cuts in 2024, with 100bps of cuts shown in the median projection, and 125bps in the following year. Under the more restrictive rate path, PCE inflation is still seen as reaching 2.1% by the end of 2025.

Recent upside surprises in data were incorporated into a higher GDP forecast for 2023 (now 1.0% vs. 0.4% previously), and a lower unemployment rate (now 4.1% in Q4 vs. 4.5% previously), with both now not far off from our forecast for end-2023. Indeed, policymakers appear to share our view that even with a stall in growth in upcoming quarters, and a rise in the unemployment rate, higher interest rates are still necessary to achieve 2% inflation on a sustained basis. By the July meeting, policymakers will likely have obtained enough additional information on labor market strength to take rates higher.

Powell noted a cooling in some labor market indicators in his press conference, including a rise in the participation rate for those aged 25-54, a softening in nominal wage growth, and lower job openings since the end of 2022. While the effects of past tightening are apparent in rate-sensitive housing activity and business investment, the consumer remains resilient, along with job gains. Powell highlighted that the conditions needed to get inflation down are in place- growth is below trend, the labor market is loosening, and the goods supply pipeline improving- but that needs to evolve for a more prolonged period of time.

If, as we expect, GDP growth moderates substantially by the end of the year, which may include a negative quarter, and inflation signals continue to moderate, reflecting the impact of past rate hikes, then the September rate increase should be the last. But we'll still need time for inflation pressures to abate in 2024, and we don't expect to see rate cuts until Q2 2024.

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