Fed to Hibernate Bond Bulls

The Fed will refrain from another rate hike when the FOMC meeting concludes on Wednesday afternoon. Chair Powell raised the bar to what would be the 11th rate hike in a row when he said last month that “We haven’t made any decisions about the extent to which additional policy funding will be appropriate. But given how far we’ve come we can afford to look at the data and the evolving outlook.” Unless the May consumer price data, released tomorrow, are exceedingly hot, a June rate pause is likely.

The futures market is discounting only a 25% chance of a June rate hike, but a slightly higher than 50% chance of a July rate hike. The market then starts to build in a small probability of a 25 basis point November 1st rate cut and is split 50/50 on the chance of a December 13th rate cut. The FOMC’s updated economic and financial projections are set to reinforce fixed income investors’ near-term bearish slant.

In March, the central tendency on 2023 real GDP growth was 0.0 to 0.8%. But since the economy is up 1.6% over the last four quarters, the central tendency on output is likely to be lifted. Our best guess is that we will see something in the vicinity of 0.5 to 1.5%. The central unemployment rate is likely to be lowered in part because of the better than earlier anticipated GDP performance but also because the rate has not increased much from where it was when the March forecasts came out (3.6%).

The central tendency on 2023 unemployment was 4.0 to 4.7%. Our best guess that we will see something in the vicinity of 3.9 to 4.5%, which is enough of a tweak to keep the Fed’s estimates of the core PCE deflator uncomfortably high, especially given the fact there has been no improvement in reducing core inflation thus far in 2023.

In March, the central tendency on 2023 core PCE inflation was 3.5 to 3.9%, and core inflation was running 4.7% year-over-year at the time. In the three months since, core inflation has been stubbornly stuck at a 4.7% annual pace so we should see its predicted range increase to somewhere around 3.8 to 4.3%. In response, the “dot plot” should show a higher terminal fed funds rate.

Our best guess is that the 2023 median dot will be increased 25 bps to 5.4% as this would only require two members to lift their estimates of the funds rate. This expected change is likely to spill over into 2024, which should show fewer rate cuts as only one member needs to change. This is consistent with the Fed’s ongoing message of keeping interest rates ‘higher for longer’ to dampen aggregate demand and quell inflationary pressures. Consequently, we expect to see the median 2024 fed funds fund dot go from 4.3% to 4.4%.

Our forecasts differ from the Fed’s in one important regard — the need for further interest rate hikes. Our economic projections are consistent with a further weakening in the labor market, which is already evident from declining hours and rising jobless claims. While core inflation may remain sticky, headline prices are declining quickly, right in line with the historical record. This means that inflation expectations will remain anchored.

When the unemployment rate rises significantly further from its current reading, we expect policymakers to pivot from worrying about high inflation to worrying about recession, especially with the 2024 Presidential Election looming. At that time, the Fed will remind us that unemployment is a leading indicator and inflation is a lagging indicator.
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