Trust must be earned

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Fed moving to a pause with a very data-dependent approach.

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- ***Fed action:*** *On 26 July, the Federal Reserve (Fed) hiked the Fed Funds rate by 25bp to 5.25%-5.50%, a 22-year high. This hike was no surprise as it had previously been well-communicated by various Fed officials.*
- ***FOMC statement:*** *The only edit to the statement was that economic activity was expanding at a "moderate" vs. previously stated "modest" pace.*
- ***Press conference:*** *The tone was measured. Chair Powell did not commit to a future rate hike, but stressed the long way to go before the inflation target could be hit. He made clear that the Fed's approach remains very data-dependent, with September a live meeting.*
- ***US economy still buoyant but inflation pressures continuing to moderate:*** *Second Quarter GDP figures released after the Fed decision surprised on the upside, with consumption and investment much higher than anticipated, with only net exports a minor drag. The Fed's preferred core PCE came in below expectations for the second quarter.*
- ***Market reaction and investment implication:*** *Absent any surprise market reaction was muted. Looking forward, we believe the Fed is setting the table for a conditional pause in monetary policy, but will tighten further if necessary. Hitting the 2% inflation target will require much weaker economic activity than the current buoyancy and the probability of achieving a soft landing is low. We remain active in duration management with a longer interest rate duration bias, and focus on high credit quality and sectors where spreads offer enough protection.*

Fed action and key communication takeaways

The Federal Open Market Committee (FOMC) raised the federal fund rate by 25bp but dropped future guidance. Chair Powell claimed that the Fed is far away from hitting its inflation target, but acknowledged that the tighter credit conditions for households and businesses could affect economic growth. We believe that the Fed is setting the table for a conditional pause in monetary policy but **we would advise caution regarding any near-term course reversal by the Fed, since the incoming economic data are not likely to support rate cuts.**

The Federal Reserve hiked the Fed Funds rate by 25bp to a range of 5.25-5.50%, a 22-year high. This was a well-communicated rate hike by various Fed officials. The Fed maintained a hawkish tone as Chair Powell left open the possibility of another rate hike depending on the trajectory of inflation and the macroeconomic data. This was evident in the FOMC's statement and Powell's press conference.

"We believe progress toward the Fed's 2% inflation target will prove to be challenging".

Minor edit to the FOMC statement

There was only one minor edit to the statement and most importantly no change to the forward guidance about "determining the extent of additional policy firming that may be appropriate". Despite the better than expected slowing in the June consumer prices, the Fed made no change to its assessment of inflation – a sign that inflation remains uncomfortably high for the Fed. The only edit was that the Fed upgraded its current assessment of economic activity from "continued to expand at a modest pace" to "has been expanding at a moderate pace". Once again, there were no dissenters in today's decision.

Press Conference: Monetary policy is restrictive

In the press conference, Chair Powell reiterated the importance of hitting the inflation target and that, while inflation has moderated since the middle of last year, it has a long way to go. Chair Powell signalled that September is a live meeting. The Fed is taking into account three factors that will help determine whether to hike at the September meeting - moderating growth, better supply/demand balance in the labour market and cooling inflation. He mentioned that monetary policy is restrictive and putting downward pressure on the economy and inflation. He referred to the real fed funds rate as being strongly in positive territory that he characterised as well above neutral. **While he did not commit to a future rate hike, the June dots suggest a further rate hike might still be appropriate. It is clear that the Fed has no preordained path to rate hikes and policy will remain data dependent.**

Market reaction and investment implications

Market Reaction: Financial markets appear sceptical about another rate hike

"We focus on high credit quality and sectors where spreads compensate for elevated macroeconomic uncertainty and tighter market liquidity".

There were no surprises in the FOMC statement, or the press conference, so the reaction in the financial markets was rather muted. The same holds true for the Fed funds futures for the November meeting that stood at 5.44%. Therefore, markets are pricing in less than a 50% probability of another rate hike.

Investment Implications

The FOMC statement and Chair Powell's press conference make it clear that the **Fed remains concerned about the high US inflation rate and will respond with tighter monetary policy if necessary**. While headline and core inflation slowed more than expected in June, we believe that progress toward the Fed's 2% inflation target will prove to be challenging as economic activity remains above trend and a resilient labour market maintains upward pressure on wages. We believe that, in order for the Fed to hit its inflation target, growth will need to weaken significantly for the current buoyant path. We should get more clarity in the coming months as we gauge the impact from the prior rate hikes and tightening lending standards on economic activity. Though the Fed desires to "soft land" both inflation and the US economy, we continue to believe the probability of success on both fronts remains low. **As such, we continue to be active in duration management with a long interest rate duration bias. We focus on higher credit quality and sectors where spreads compensate for elevated macroeconomic uncertainty and tighter market liquidity.**

Second Quarter GDP data released a day after, would, on balance, make the Fed's dilemma more difficult. Real GDP increased at an annualised 2.4%, well above expectations of 2%, with real consumption 1.6% higher, and a strong increase in business fixed investment spending up 7.7%. Investment continues to be boosted by federal incentives. With such strong domestic demand, core PCE would have been expected to remain elevated. Instead, it came in well below consensus expectations at 3.8% for Q2. While the inflation data continue to look favourable, the resilience of the economy may not give the Fed sufficient comfort that inflation will continue to come down gradually toward its target.

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Definitions

- **Basis points (bp):** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Monetary policy reaction function:** A function that gives the value of a monetary policy tool that a central bank chooses, or is recommended to choose, in response to some indicator of economic conditions
- **Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.

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