William Blair

FOMC Meeting

Fed Pauses in June, Further Increases Likely

Equity Research
Economics

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FOMC Summary of Economic Projections - June 2023

	2023	2024	2025	Longer run
Change in real GDP	0.7 to 1.2	0.9 to 1.5	1.6 to 2.0	1.7 to 2.0
March projection	0.0 to 0.8	1.0 to 1.5	1.7 to 2.1	1.7 to 2.0
Unemployment Rate	4.0 to 4.3	4.3 to 4.6	4.3 to 4.6	3.8 to 4.3
March projection	4.0 to 4.7	4.3 to 4.9	4.3 to 4.8	3.8 to 4.3
PCE Inflation	3.0 to 3.5	2.3 to 2.8	2.0 to 2.4	2.0
March projection	2.9 to 3.8	2.2 to 2.8	2.0 to 2.2	2.0
Core PCE Inflation	3.7 to 4.2	2.5 to 3.1	2.0 to 2.4	
March projection	3.5 to 3.9	2.3 to 2.8	2.0 to 2.2	
Federal funds rate	5.4 to 5.6	4.4 to 5.1	2.9 to 4.1	2.5 to 2.8
March projection	5.1 to 5.6	3.9 to 5.1	2.9 to 3.9	2.3 to 2.5

Highlights

- **Rates** – The Fed made no change to the fed funds policy rate, which currently sits between 5.00%-5.25%, though it made clear it is fully preparing to resume increases in July (and beyond) if required.

- **Fed's Balance Sheet** – The Fed made no change with respect to QT, which is capped at $95 billion per month ($35 billion in MBSs and $60 billion in Treasurys).

- **Voting** – There were no dissenting voters.

Fed Pauses but Leaves the Door Wide Open to Further Increases

In light of most leading economic indicators deteriorating sharply over the last year, problems still simmering in the banking system, likely future weakness emerging in the commercial real estate market, some possible further upward pressure on short rates as the Treasury starts to rebuild its TGA (savings account at the Fed), and inflation that is not yet back to 2% (but clearly moderating, further raising real rates), the Fed felt the right thing to do at this juncture was to take a breather and allow a little more time for the long and variable lags from higher interest rates to continue to work their way through the system.

Conversely, the Fed is still seeing consumer spending figures (at least in nominal terms) that are holding up well, sentiment from the corporate sector that is also generally still solid, employment growth that is similarly resilient, and a housing market that could be starting to recover despite 7% mortgage rates.

From the Fed's persective, it is also a risk management world. With its reputation already tarnished from excess COVID-related stimulus; Fed officials trading their own portfolios; continuing QE for far too long and then being slow to raise rates; its transitory view of inflation; and then falling asleep at the wheel when it was supposed to be watching out for the rocks of potential regional banking stress—it unfortunately does not have a ton of credibility left in the tank to draw down on.

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As a result, the Fed really cannot afford to get this call wrong again either. If it pauses too early, inflation/inflationary expectations spike up again, and it has to chase rates higher, it will lose even more credibility and have an even-harder time shaking the view that it is the worst Fed since Arthur Burns or G. William Miller.

On the flipside, there is seemingly everything to be gained by adopting a more hawkish stance, adhering to the Volcker mantra of "keeping at it," and making sure that inflation is definitively crushed—even at the expense of at least a moderate recession—before overtly pausing and then starting to lower rates once again.

The Fed is also fully aware that the transmission mechanism for its policy decisions are financial conditions, and by signaling a definitive pause too soon, it would be justifiably worried that market participants will immediately jump the gun and start to anticipate rate cuts, thereby easing those financial conditions before the Fed might feel is really appropriate.

This is the downside of less credibililty. With more in the tank it would have a greater ability to wait and see. With less credibililty, it is forced to reestablish its inflation-fighting credentials, which are entirely asymmetric in nature—hard to build, but easy to lose.

Aside from reputational issues, the Fed also knows just how important it is to get inflation back down given the very real punitive impact it has on many middle- and lower-income households.

Sadly, because of this, there is a growing probability of over-tightening. Chair Powell has been telling us that he wants to definitively see services inflation falling, but he is also keen to remind us that services inflation is primarily driven by wages—very much a lagging indicator.

Hence looking forward, the bar for a further rate increase or two is very low, relative to that for cutting rates, which is now very high. As such, we suspect that the Fed will want to at least see a few negative employment prints (nonfarm payrolls) before making a tangible policy shift toward actually easing.

Highlights From the Summary of Economic Projections

In terms of changes to its economic forecasts, the Fed now sees 2023's economic growth coming in much higher than it estimated in March, though relatively the same in the coming two years. It sees unemployment being a little lower than previously anticipated, but the range of possible inflation very moderately higher in the coming two years. As a result, the lower bar for the range of expectations around the funds rate moved tangibly higher for 2023 (i.e., actually pointing to another rate increase) and in 2024, while the top end of the range for 2025 almost moved higher.

The Fed also increased the longer-run expected rate of interest from 2.6%-2.6% to 2.5%-2.8%; this is consistent with a higher estimated rate of r-star (the real neutral rate of interest), with the increase seemingly in line with the revised estimates put forth by r-star guru John Williams from the New York Fed.

Conclusion

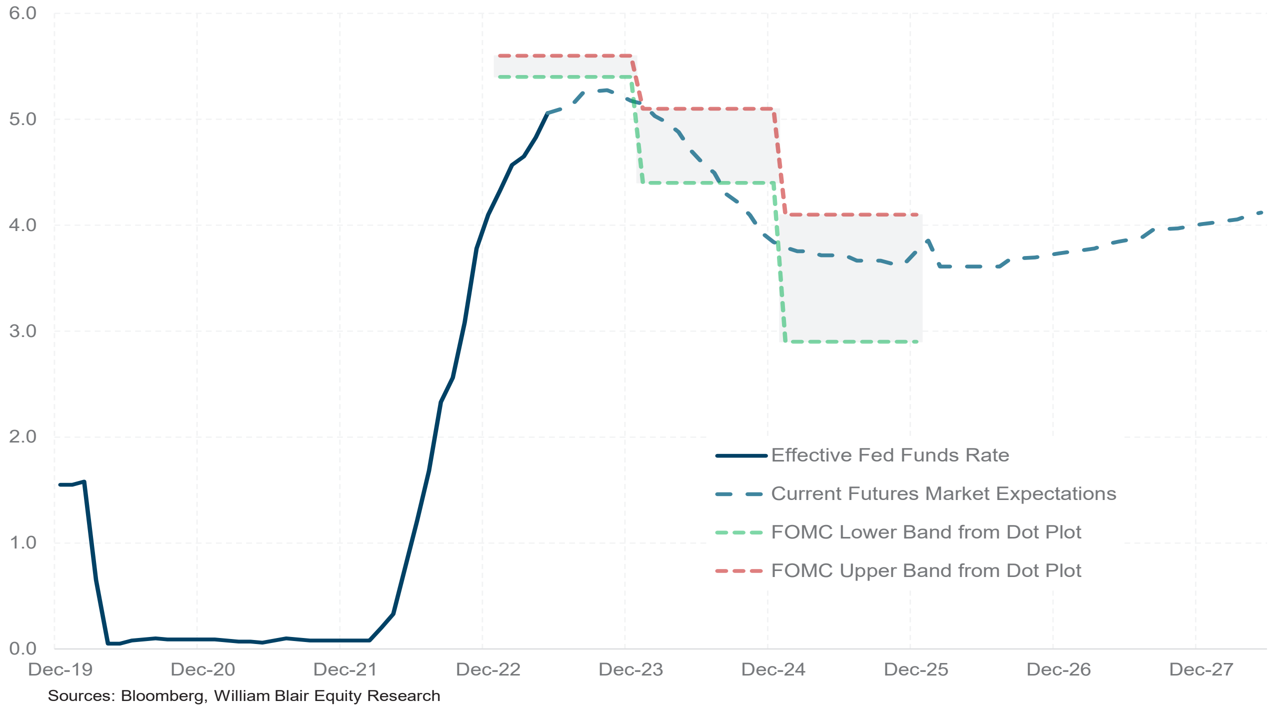
This was a very hawkish pause from the Fed. It feels that growth and inflation are still not yet contained enough to warrant a clear pause—which merits the question, why not raise again at this meeting? The answer is probably down to messaging and typically wanting to transmit a clear signal on future rate changes to the market before actually making them. Given much of the strength in the economic data has come from more recent data reports, the Fed may have felt there was not enough time to adequately prep the markets ahead of time.

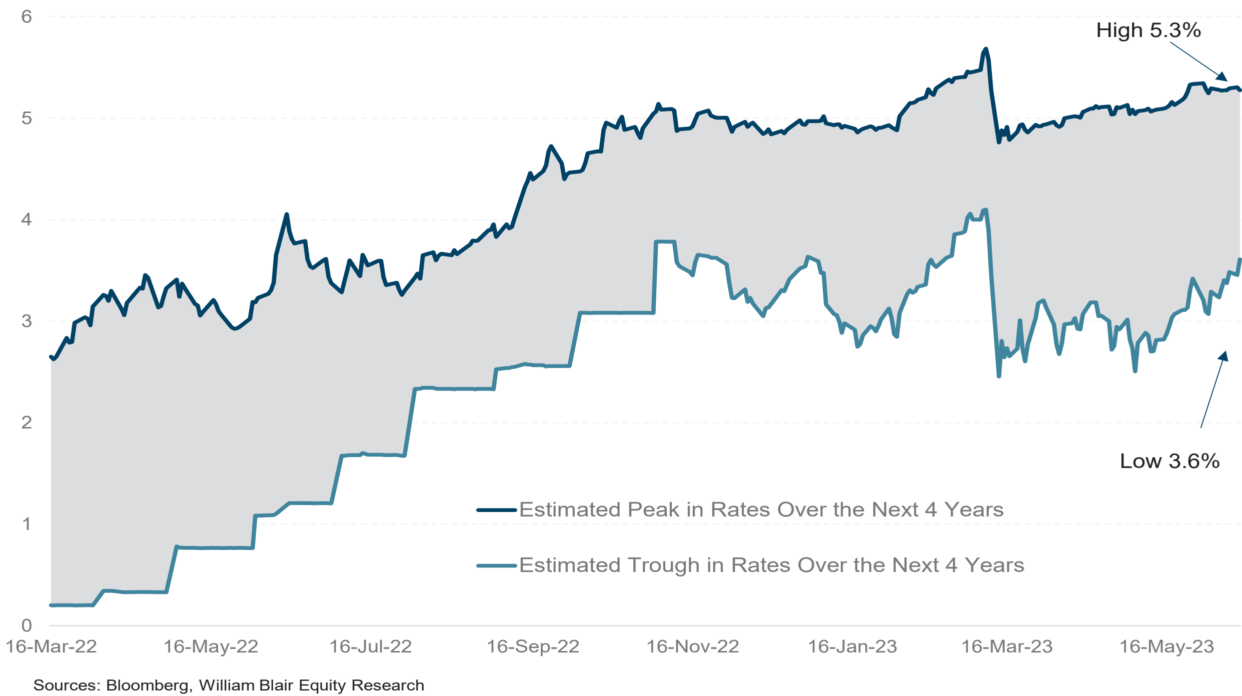
The Fed is also trying to balance the ongoing need to bring down still-high inflation and inflationary expectations—which are being accompanied by the still-strong employment, wage data, and consumer spending—with evidence from just about all leading economic indicators that the economy is heading toward a downturn.

Powell yet again told us that the Fed is "*acutely*" aware of the significant cost to many households from too-high inflation, and that it has also learnt the lessons from former Fed Chairman Volcker—much lauded in the pantheon of Fed chairs—about "keeping at it."

The Fed will also know that central banking credibility tends to be asymmetric—hard to gain, but easy to lose. If it had greater credibility today, we suspect the Fed would have far more leeway in its messaging around keeping rates on hold for a little longer and not threatening more increases in the pipeline.

Nevertheless, at today's meeting Powell made it clear that further rate increases are in the pipeline unless something dramatic happens between now and the July meeting. Yet, with monetary policy arguably already in the moderately restrictive zone, and inflation steadily falling (further tightening policy via higher real rates), the potential for a policy mistake and overtightening is clearly increasing.


Fed Funds Rate, Futures Market Expectations & FOMC Projections, %
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Dec-19
Dec-20
Dec-21
Dec-22
Dec-23
Dec-24
Dec-25
Dec-26
Dec-27
Effective Fed Funds Rate
Current Futures Market Expectations
FOMC Lower Band from Dot Plot
FOMC Upper Band from Dot Plot
Sources: Bloomberg, William Blair Equity Research


Progression of Expected Range for Fed Funds Rate in Next 4 Years,
(Fed Funds Futures Pricing, %)
6
5
4
3
2
1
0
High 5.3%
Low 3.6%
Estimated Peak in Rates Over the Next 4 Years
Estimated Trough in Rates Over the Next 4 Years
16-Mar-22
16-May-22
16-Jul-22
16-Sep-22
16-Nov-22
16-Jan-23
16-Mar-23
16-May-23
Sources: Bloomberg, William Blair Equity Research

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DOW JONES: 34066.30
S&P 500: 4338.93
NASDAQ: 13461.90

Additional information is available upon request.

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Market Perform (Hold)	26	Market Perform (Hold)	3
Underperform (Sell)	1	Underperform (Sell)	50

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