US Federal Reserve Monetary Policy Expectations – H2 2023

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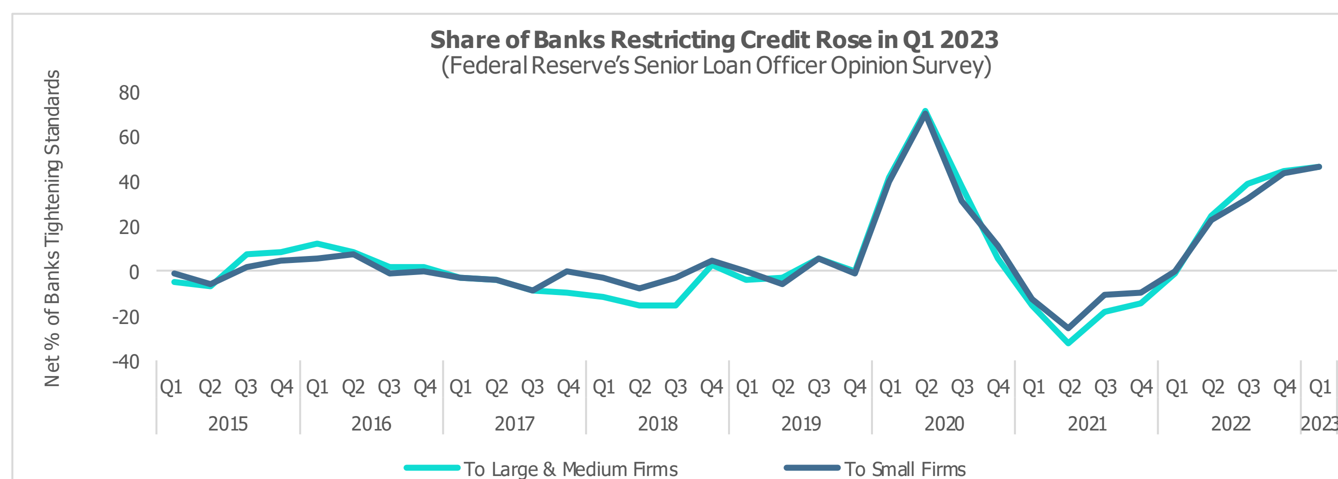
CareEdge RATINGS

Banking sector turmoil that emerged in March 2023 set off the narrative that a faster pace of tightening credit conditions would push the US economy into a recession. While a slowdown may well be on the cards this year, a hard landing is still debatable. In this report, we look at the state of the US economy through the lens of credit conditions, the labour market, growth, and inflation to gauge the Federal Reserve's monetary policy actions in the remainder of 2023.

Credit Conditions to Tighten Further in 2023

The Senior Loan Officer Opinion Survey released by the Federal Reserve in May reported tighter lending standards and weaker demand for commercial and industrial loans in the first quarter. The scenario was in fact worse across commercial real estate categories. The report signals that banks have begun feeling the impact of the Fed rate hikes, the most rapid pace of tightening in over four decades. Banks cited an expected deterioration in the credit quality of their loan portfolios and in customers' collateral values, a reduction in risk tolerance, and concerns about bank funding costs, bank liquidity position, and deposit outflows as reasons for expecting to tighten lending standards over the rest of 2023. The survey to be released in July would most likely tell us the extent to which the bank crisis has affected lending. Tighter lending standards and weak credit demand against the backdrop of high borrowing costs are likely to intensify recessionary forces. Not to forget, the lagged impact of a total of 500 bps of Fed rate hikes is yet to play through the economy.

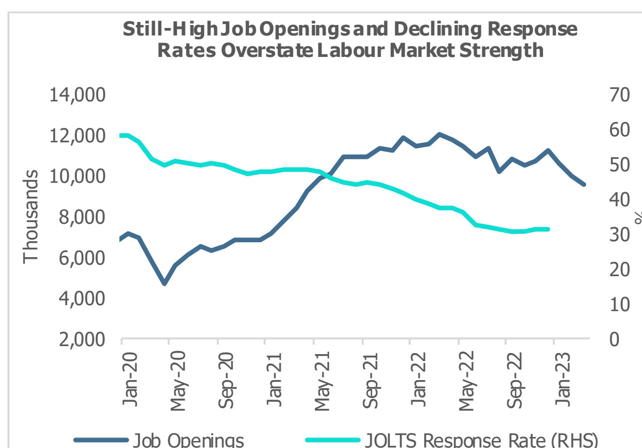


Source: US Federal Reserve

Even while business activity, labour market and wage growth are not yet explicitly signalling trouble, the problem may arise when the sovereign debt would have to be refinanced at higher rates. The interest-rate sensitive real estate sector would likely be the first to take the hit. As per reports, around USD 1.5 trillion of commercial real estate debt is due for repayment before the end of 2025. The Fed's Financial Stability Report has also identified that a correction in property valuations amidst a shift towards telework in many industries could lead to credit losses for holders of commercial real estate debt. The Fed also said that the sharp jump in borrowing costs over the past year increases the risk that commercial mortgage borrowers won't be able to refinance their loans as they come due.

Labour Market Begins to Cool, But Slowly

Despite signs of cooling of labour demand, US labour markets are still tight by historical standards. The JOLTS report showed that job openings have declined by 2.4 million since the peak seen in March 2022. This however remains 2.9 million above February 2020 levels. More notably, the job opening numbers must be read with caution given that response rates have declined sharply. Response rate i.e. the percentage of establishments that respond to the survey has halved to 31% by end-2022, most likely overstating the tightness in labour markets.

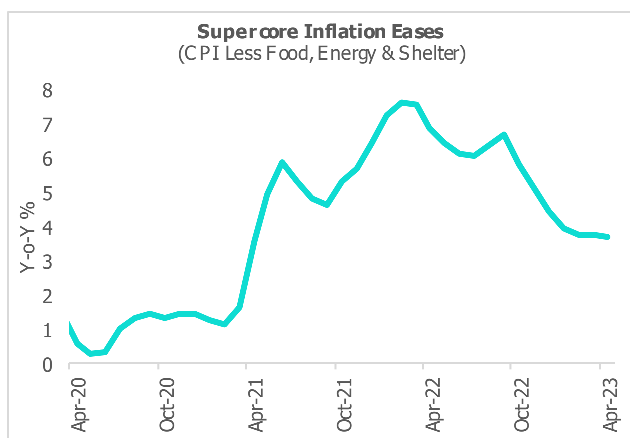


Source: Refinitiv, US Bureau of Labour

Even when looking at the headline nonfarm payroll figures that reported strong growth of 339K in May, there have been notable revisions over the past few months. Since the start of this year, payrolls have been revised lower by a total of 127K from the initial release. The headline NFP number in May being well above 190K forecasted is however just one part of the picture as wage growth and the unemployment rate disappointed. Wage growth slowed to 0.3% M-o-M in May, while the unemployment rate rose off historic lows of 3.4% to 3.7% in May. For the Federal Reserve, an annualized pace of wage growth of around 3-3.5% would be consistent with meeting the 2% inflation target. Currently, wage growth is at 4.3% y-o-y. Looking ahead, with banks tightening lending standards over the course of the year, the unemployment rate is likely to move higher in 2023.

Inflation Moving in the Right Direction

Recent inflation prints, for both CPI and core CPI, have offered evidence of sustained moderation in price pressures. CPI and core CPI rose 5% and 5.6% y-o-y in April, well off their peak of 9.1% and 6.6% seen in June 2022 and September 2022, respectively, suggesting that the Fed's past rate hikes are working through the economy. Inflation, excluding food, energy, and housing, which is what the Fed believes contributes to upward pressure on wages, has shown encouraging signs of easing. Additionally, sticky shelter costs (which account for 34% of the CPI basket) are showing signs of topping out.



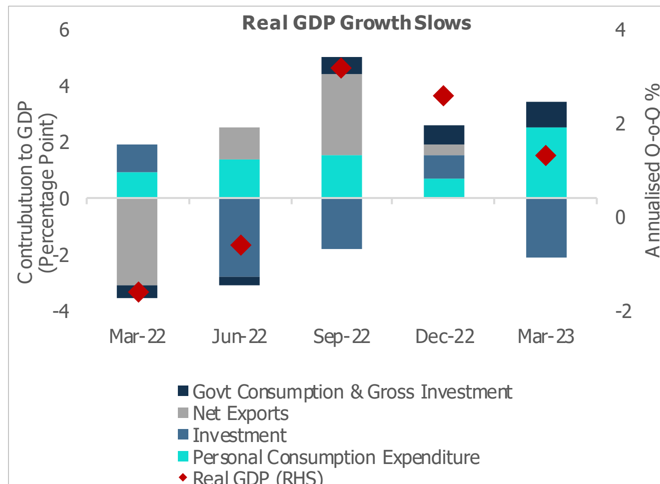
Source: CEIC

On a month-on-month basis however, barring March, both CPI and PCE inflation has remained elevated at an average of 0.4% in the year so far. As per the Fed's median projection, PCE inflation is expected to ease close to the 2% target only by Q4 2025. This suggests that the sequential momentum would need to slow considerably for the Fed to achieve this target. For 2023, the PCE inflation projection is 3.3% by Q4, well below the average 5% seen in Q1.

Contraction in GDP Growth on the Cards

Advanced estimate for Q1 GDP showed that the economy grew 1.3%, with consumer spending (3.8% Q-o-Q annualized) being the main driver that offset a decline in inventories. However, the strong consumption growth story in Q1 was largely supported by a one-off surge in real personal incomes in January. This can be further validated by the sequential momentum in retail sales that registered a contraction in February and March after a sharp uptick in January. Preliminary data for April suggests that while expenditure has picked pace, with disposable

income flatlining, it is unlikely that robust consumption would sustain. As a result, we believe the positive contribution that we see from consumption expenditure could temper going ahead.



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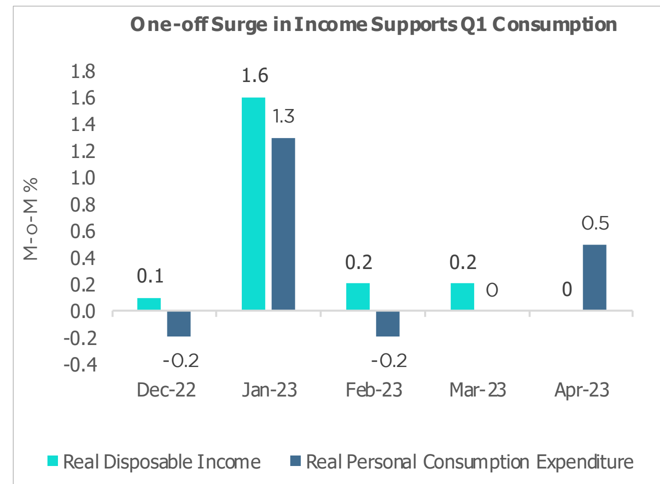

Source: US Bureau of Economic Analysis

So far, savings and credit card debt has borne the brunt of rising prices to meet consumer demand. However, with savings depleting and credit conditions tightening, demand could cool in the coming quarters. Meanwhile, fixed investments have contracted for the past four quarters, with slowing activity in the housing sector posing as a drag. Amongst investments, the decline in private inventories has also contributed to the slowdown in GDP. Declining inventories suggest businesses have been replenishing stocks at a slower rate. If we exclude the decline in inventories (from the percentage point contribution to Q1 GDP), real GDP is seen higher at 3.4%. Going ahead, manufacturing activity, gauged by the PMI numbers has moderated in recent months, with most of its sub-components moving into the contractionary zone. Services PMI in comparison is however holding up well so far. Overall, consumer demand and business activity are expected to cool further as the full impact of rate hikes works its way through the economy. As a result, a mild technical recession in the coming quarters could be on the cards. As per the Fed's Summary of Economic Projections released in March, the median projection of 18 FOMC members shows GDP growth at 0.4% by Q4 2023, after growing 0.9% a year ago.

US Rates Outlook

Looking at the state of the economy at the current juncture, it is reasonable to assume that the Federal Reserve may not achieve its inflation target without hurting the economy. The combined effect of past rate hikes and reduced credit availability is expected to lead to a deterioration in growth and employment in 2023, the latter of which has already begun playing out. At the May FOMC meeting, the Fed hinted at keeping rates higher for longer, by, on one hand dropping the reference to 'additional policy firming' post a 25 bps hike, and on the other, pushing back against the possibility of rate cuts. The minutes too revealed that several members approved that rates may not need to rise further. Inflation remaining way off the 2% target convinces us that the Fed may not wish to sound dovish just yet. The probability of monetary policy easing got priced out to a large extent after the banking sector crisis was contained. While we do expect the economy to falter going ahead, it is likely that a hard landing could be averted, for two reasons--i) inflation has begun easing without a catastrophic impact on output, ii) the Fed kickstarted its tightening cycle at a time when employment and job creation were near record highs. That said if we see the unemployment rate rising faster than the Fed's expectations (4.5% by Q4 2023), policy bets could quickly shift towards rate cuts. The June FOMC meeting outcome is however a close call. While we expect the Fed to pause, the inflation reading for May will have a significant bearing on the Fed's guidance. Moreover, the removal of the debt ceiling until January 2025 and the resulting issuance of fresh debt would have a tightening effect on financial conditions, which the Fed could take into consideration. A hotter-than-expected inflation print however could keep the door open for rate hikes going ahead. The possibility of rate cuts this year however looks dim as the Fed would prefer not to jump the gun before getting a handle on inflation. To conclude, rates could remain higher for the remainder of 2023, with chances of rate cuts in 2024.

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