The Federal Reserve Open Market Committee elected to make no change to policy interest rates today, keeping the Fed funds rate at the 5.00-5.25% level from the May meeting. The vote was unanimous.

The formal statement was also little changed from May, with a language update of 'economic activity expanded at a modest pace' to 'recent indicators suggest that economic activity has continued to expand at a modest pace.' Also, that holding the target rate steady 'allows the Committee to assess additional information.' The statement kept further rate hikes on the table, as in May. In the quarterly summary of economic projections (SEP), the new terminal rate projection rose to 5.6% from 5.1%, with increases of a few tenths for the next several years—pointing to a more hawkish path in the near-term than financial markets expected (explaining a reversal in stocks downward).

Today saw the first pause in the current cycle since it began just over a year ago, which was a foregone conclusion in Fed funds futures[1] markets over the past few weeks. However, this was referred to as a 'hawkish pause' or 'hawkish skip' (for those wanting buzzwords) as future moves remain possible, with a 0.25% hike still showing better than 50/50 odds for July. By year-end 2023, the current 5.00-5.25% remains the highest probability expectation (up from earlier opinions for cuts of up to a percent), while year-end 2024 continues to show a far lower 3.50%. The obvious signal is that markets continue to expect a series of cuts at some point, assuming to combat a recession, although potential timing of that has been pushed out further yet again.

Economy. U.S. economic growth remains positive, with Q1 GDP[2] revised up to 1.3%. For Q2, the Atlanta Fed GDPNow[3] measure expects 2.2% growth, and the median Blue Chip economist forecast has risen from 0% to just under 1%. Economist opinions about growth have become more optimistic, with recession odds for 2023 coming down, although checklists of classic leading indicators still point to a high downturn probability. The SEP pointed to growth estimates of 1.0%, 1.1% and 1.8% for 2023, 2024, and 2025, respectively—an upgrade of a half-percent in 2023 from the March assumptions, while the next two years ticked down a tenth. The simple story is that the broad economy remains bifurcated, with services sectors continuing to expand, while manufacturing is contracting. Challenges to banks, ironically brought on by the Fed's own hiking actions over the past year, are expected to further tighten the availability of credit. This could trim up to a half-percent or so off potential GDP, which may or may not be enough to cause a dip into recession.

Inflation. The May Consumer Price Index[4] report this week showed trailing 12-month headline and core inflation decelerating to 4.0% and 5.3%, respectively. Producer price inflation also decelerated to just over 1% year-over-year. CPI has remained stickier than expected, largely due to food and shelter, but energy prices falling -20% certainly helped. Progress in other sectors has been mixed. The Fed member PCE price inflation estimates for 2023, 2024, and 2025 came in at 3.2%, 2.5%, and 2.1%, little changed from March, and showing optimistic normalization toward the 2.0% target. These still-high levels point to the possibility of the Fed raising hikes a bit further in coming months after pausing, depending how persistent inflation remains—as seen in the recent hawkish re-starts by the central banks of Canada and Australia. All else equal, the Fed has made it clear that, absent a strong downturn, hiking could continue as long as inflation remains above target. However, 'tightening' elsewhere, such as through credit and falling M2 and M3 balances have provided an assist.

Employment. The unemployment rate[5] for May ticked up by 0.3% to 3.7%, to break out of its recent trough, with labor markets finally showing signs of some weakening at the edges. Though, in keeping with economic trends generally, services labor (most jobs) remains strong, while goods-producing jobs (far less) have fallen back. The newest SEP estimates for the unemployment rate have come in at 4.1%, 4.5%, and 4.5% for 2023, 2024, and 2025; these are all a bit down from the March readings. That said, despite the moderating pace, job markets are far from weak. Nonfarm payrolls continue to run at a strong level, with particular discretionary areas (like recreation and restaurants/bars) continuing to rebuild from pandemic lows. The size of the labor force has shrunk due to retirements, government benefits, and slower immigration, all of which have continued the mismatch. This has also kept wage inflation higher, although that's also shown signs of moderation. It appears that worries of a wage-price spiral may not come to pass, but, as with inflation generally, wage growth has remained a bit sticky.

The suspension of the U.S. debt ceiling removed some uncertainty, but from a technical side, it created a deficit of government funding. That gap now must be refilled via the issuance of treasury bills, where higher supply could push short-term rates higher for a bit longer, perpetuating the current yield curve inversion. However, long-term rates have stabilized around the point where markets seem to agree on long-term expectations for inflation and economic growth. (A very rough rule is that the long-term treasury yield shouldn't veer too far from the nominal GDP growth rate, which is the normally quoted 'real' GDP growth rate plus inflation. An era of zero short-term rates certainly distorted this relationship.) Due to the duration effect, a rate cut could cause these rates to fall as well, which is why a temptation to overload on high short-term debt to the exclusion of intermediate-term debt might be short-sighted.

The concept of 'neutral' is something the Fed discusses often. It's the rare, albeit imperfect, place where risks appear balanced on the upside and downside. Consequently, as those two opposing forces offset, minimal or no policy action would be the appropriate response. The Fed raises interest rates to slow the economy, so such an outcome shouldn't be surprising. With inflation still high (but decelerating) and economic growth showing mixed signals (both expansion and contraction), this might be as close to 'balanced' as we can expect. Of course, as history shows, such a place doesn't last indefinitely, as one side begins to overtake the other. For now, the relative stability could be appreciated by financial markets, as this leads to better predictability for discount and lending rates.

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Sources:

[1]CME Group (https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html)
[2]U.S Bureau of Economic Analysis (https://www.bea.gov/data/gdp/gross-domestic-product)
[3]Federal Reserve Bank of Atlanta (https://www.atlantafed.org/cqer/research/gdpnow.aspx)
[4]U.S. Bureau of Labor Statistics (https://www.bls.gov/cpi/, https://www.bls.gov/ppi/)
[5]U.S. Bureau of Labor Statistics (https://www.bls.gov/news.release/pdf/empsit.pdf)