GENERALI INSURANCE ASSET MANAGEMENT

MARKET COMMENTARY

The Fed pauses, but hiking looks far from finished

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- **The FOMC paused rate hiking but delivered a hawkish surprised by increasing by 50 bps its year-end target for the policy rate. It follows an upward revision of the short-term expectations for growth and above all core inflation. Despite little change in the economic projections for 2024 and 2025, the FOMC projects a higher policy rate also then.**
- **In the Q&A session, chair Powell tried to reassure about the outlook for inflation and rates. The labour market is going back into balance and this will help disinflation, but the recent data show that price pressures remains too high and this is behind the almost unanimous decision to raise rates further.**
- **Powell conceded that the full impact of the past rate hikes and the banking stress have not been unfolded in full and how the economy will react remains uncertain. This latest hawkish turn, if implemented, will add further pressure to an economy that we see entering into recession after the summer.**

The pause in rate hikes was widely expected and communicated, and over the past weeks there were strong hints to the possibility of new rate rises. What surprised in the June meeting was the possible extent of such increase: the FOMC now sees it appropriate to lift the policy rate to the 5.5-5.75% range, i.e. a full 50 bps higher than what envisaged in the March dots and basically back to the expected level prevailing before the bank turmoil. Rates are projected to remain higher also in 2023 and 2024.

The press statement signalled that the economy continues to expand at a “modest” pace which nevertheless is delivering strong employment gains. But given the persistence of strong inflation the issue of additional hikes has become one of “how much” rather than “if”. This hawkish tilt derives from an upward revision of the outlook for the inflation and economic activity in the second half of this year, in turn motivated by the fact that economic data have consistently surprised to the upside in the last months. Projections for 2024 and 2025 were not revised significantly. Therefore, despite rates remaining at 90bps above the neutral value in 2025 and with growth well below potential, the unemployment rate is still expected to increase only moderately and stabilise only slightly higher than its estimated neutral value.

In the Q&A section chair Powell downplayed the role of the dots and the projections especially at longer horizons. But he reiterated the fact that what is needed to bring inflation to a downward path, first and foremost a better balance between labour demand and supply, is coming into line. It will only take time before the cooling of the labour market affects inflation in the labour-intensive ex. housing service sectors, which remains the focus of attention of the FOMC. Inflation dynamics has changed and going forward the labour market is expected to play a more prominent role, in line with the conclusions of a recent paper co-authored by former chair Bernanke that he explicitly quoted.

The possible inconsistency among this rather benign view of the inflation outlook, the not so optimistic growth forecasts, today’s pause, and the need for higher rates, begged for a lengthy explanation. Powell stressed that the pause (or skip) in rate hikes is consistent with the gradual reduction in the pace of tightening and with the need to assess the impact of the moves implemented so far and the fallout of the banking turmoil. The decision to raise the terminal rate was a separate one (which 16 out of 19 members agreed on), which reflects the new data on activity and inflation. To dispel any expectation/hope of guidance, Powell

repeated that decisions will be taken meeting by meeting and the July one will be live in term of possible rate hikes. He stressed that all FOMC members are fully committed to do ”whatever it takes” to tame inflation (which however is expected to remain above target until the end of 2025) and that none “pencilled in a rate cut this year”. According to him there still exists a path to achieve price stability without inflicting too many damages to the labour market but conceded that the risks of doing too little and doing too much are in much closer balance now than a fer months ago. Yet risks to inflation remains tilted to the upside.

He spent relatively few words on financial stability as he deems that it is still too early to assess the impact on the banking stress on the real economy. The exposure of many small lenders to commercial real estate is a concern also because the crisis in that sector will not be solved soon. But losses should be well distributed across the banking sector, which in the end should be able to withstands the blow.

We will revise our forecast for the Fed funds rate, but if our baseline scenario of GDP contraction in H2 materialises it will be very hard for the Fed to keep a hawkish posture even if inflation remains sluggish.

Market reacted sharply to the hawkish surprises but seemed to be quite convinced by the explanation provided in the Q&A session. The yield on the 2-year Treasury briefly exceeded 4.7% before retrenching to 4.65%, more than 10 bps higher than at the beginning of the day. The S&P quickly pared the initial loss.

	2023	**2024**	**2025**	**Longer run**
GDP growth (Q4/Q4 ann.)	1.0	1.1	1.8	1.8
Mar. projections	0.4	1.2	1.9	1.8
Unemployment rate	4.1	4.5	4.5	4.0
Mar. projections	*4.5*	*4.6*	*4.6*	*4*
PCE infl. (Q4/Q4 ann.)	3.2	2.5	2.1	2.0
Mar. projections	*3.3*	*2.5*	*2.1*	*2.0*
Core PCE infl. (Q4/Q4 ann.)	3.9	2.6	2.2	-
Mar. projections	*3.6*	*2.6*	*2.1*	-
Appropriate path for the policy rate				
Federal funds rate	5.6	4.6	3.4	2.5
Mar. projections	*5.1*	*4.3*	*3.1*	*2.5*

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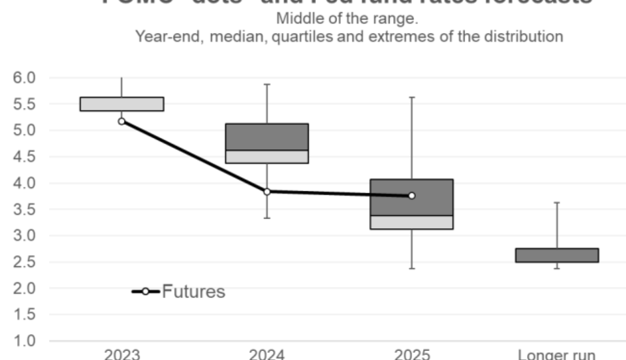

Source:Federal Reserve Board, Datastream,GIAM estimates

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Variable	Prev. FOMC meeting	Latest	Chg.
Real Activity			
Weekly activity index (yoy GDP)	0.8	1.0	0.1
ISM - Manuf	47.1	46.9	-0.2
ISM - Services	51.9	50.3	-1.6
Macro Surprises	16.6	18.7	2.1
Labor Market			
Payroll growth (3 mth. MA)	313	253	-60
Unemp. Rate	3.5	3.7	0.2
Unemp. Rate (broad)	6.7	6.7	0.0
Hourly wages, % yoy (3 m. MA)	5.2	5.0	-0.2
Prices			
Core CPI	5.6	5.3	-0.3
Core PCE	4.6	4.7	0.1
Trimmed PCE	4.7	4.8	0.1
U. Mich 5 yr exp.	3.0	3.1	0.1
NY Fed 3 Y exp.	2.9	3.0	0.1
5Y5Y fwd exp.	2.2	2.3	0.0
Financial Conditions			
Chicago Fed index*	-0.2	-0.3	-0.1
10 yr. Treasury	3.4	3.8	0.5
- Risk neutral Component	4.0	4.4	0.4
- Term Premium	-0.7	-0.6	0.1
Yield curve (10Y - 3m)	-1.9	-1.4	0.4
S&P 500	4091	4369	6.8%
Trade Wighted Dollar	127.6	128.7	0.8%
WTI Crude Oil	68.6	69.4	1.2%

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