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Global Markets Research

Research Alert

# Intense Fed hiking may accelerate growth slowdown

- **Fed may take on another 75bp rate hike come July, but we expect 50bp increase**
- **Engineering a soft landing proves tricky as domestic conditions soften**
- **Hard-to-control external factors may still drive pipeline inflation**

The Federal Reserve has increased the fed funds rate target range by 75bps to 1.50-1.75%, from 0.75-1.00% previously. This marked the Fed's third consecutive rate hike since March (+25bps) and May (+50bps) as the central bank began its policy normalisation this year. The last time the Fed adjusted rates by 75bps at one meeting was back in 1994 during the Alan Greenspan era when the price situation was wholly different. The outsized move matched the markets and economists' expectations that were spurred only in recent days following the red-hot US inflation data. Up until last Friday, the market had largely been looking at a 50bp hike, a continuation from the Fed's May decision and an outcome of Fed officials' careful shaping of forward guidance for weeks.

**Dot plot suggests additional 175bps hike ahead**

The decisive move reinforces the Fed's long standing inflation fighting credibility, recognising finally the need to take bolder measures this round in the wake of the 40Y high CPI inflation rate (8.6%) and after having fallen severely behind the curve. The dot plot showed all 18 officials expecting the Fed to bring rates up to at least 3.00% this year. The median forecast for the fed funds rate was adjusted higher to 3.375%, compared to 1.185% in the March projections. This means that compared to the current median rate of 1.635%, there will be an additional 175bps adjustment in the coming months, spreading over the July through December meetings. We however expect another 50bps hike in July, 50bps in September and two separate 25bps in November and December. Fed Chair Powell had said that we may see a possible 75bp or 50bp hike in July.

**Fed trimmed outlook as data turned weaker**

The Fed unsurprisingly trimmed its growth and labour market outlook as the stubbornly high inflation erodes consumer spending. The real GDP growth forecasts were cut and unemployment rates revised higher for 2022 through 2024. The Fed wishes to avoid a recession in 2H22 while bringing down inflation although the situation could prove tricky to manoeuvre. Powell warned of exogenous factors that were beyond the central bank's control that may contribute to high inflation; the obvious ones being the Ukraine-Russia conflict which would drive up prices via the energy and food channels, not to mention China's strict Covid policy that could exacerbate the supply chain bottlenecks.

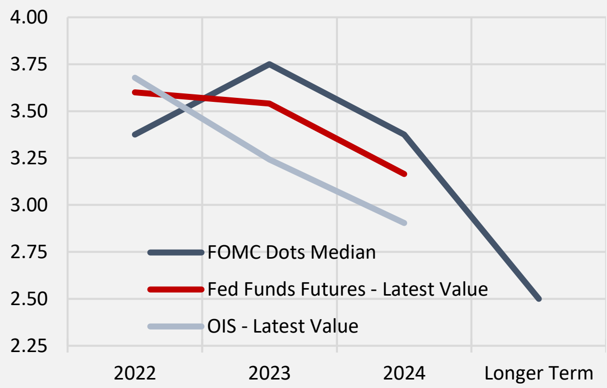
**Figure 1: Fed revised down growth forecasts**

| | Median Projections | | |
|---|---|---|---|
| | **2022** | **2023** | **2024** |
| Real GDP growth | 1.7 (2.8) | 1.7 (2.2) | 1.9 (2.0) |
| Unemploy-ment rate | 3.7 (3.5) | 3.9 (3.5) | 4.1 (3.6) |
| Core PCE inflation | 4.3 (4.1) | 2.7 (2.6) | 2.3 (2.3) |
| Fed funds rates | 3.4 (1.9) | 3.8 (2.8) | 3.4 (2.8) |

Figures in () are March projections

*Source: FOMC Summary of Economic Projections*

**Figure 2: Markets pricing in lower rates in 2023 onwards**

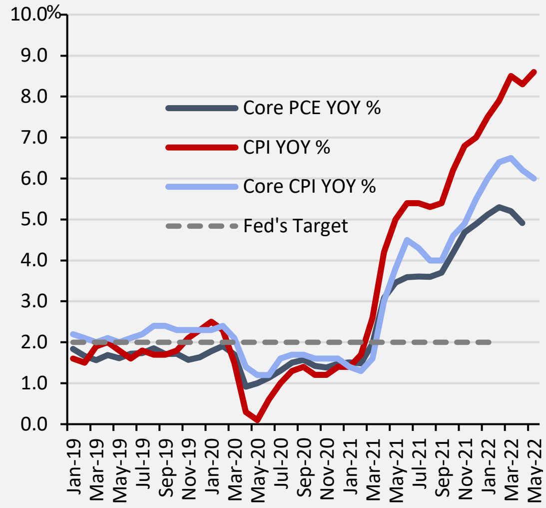



*Source: Bloomberg*

On the domestic front, consumer-related data have been less rosy in recent weeks, as evident in the 0.3% m/m decline in retail sales and the record low consumer sentiment. After all, consumers may have less deep of a pocket to dig into this year, as the American savings rate dropped to 4.4% in April, the lowest since September 2008 during the height of the Global Financial Crisis. The continued downtrend in the 4-week initial jobless claims hints at a slowdown in hiring activity; while partly attributed to the rampant labour shortages, weakening business and investment sentiment plays a role too. On the production side of things, regional manufacturing conditions have been showing weakness while the overall housing market is poised for further cool-down.

Barring from the escalation of the above-mentioned external factors that would drive pipeline inflation (Ukraine and China), so long as the Fed ramps up tightening this summer through fall, we think that inflation may soon embark on an easing trend, as oil prices are expected to come off, thanks to the OPEC+'s gradual output increase and weaker global demand would have caught up by then. Domestically, the weaker appetites for pricier durable goods and the softening wage growth and housing market should be an added advantage to tame inflation.

**Figure 3: Stubbornly high US inflation**




*Source: Bloomberg*

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