June 12, 2023

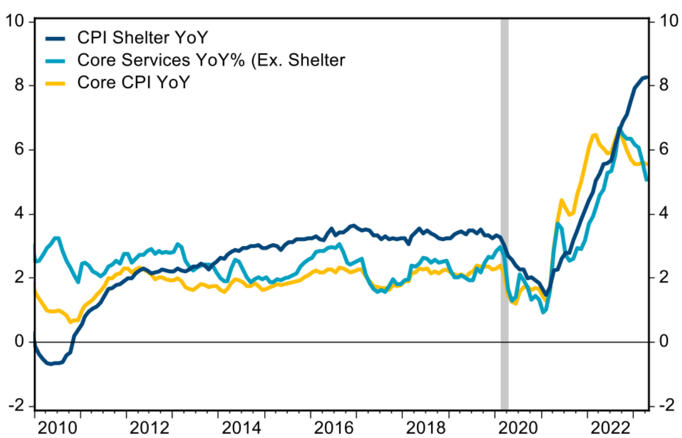
Economic INSIGHT

A Skip in June, Reengage in July

Amid a slew of uneven data, the Federal Reserve (Fed) has indicated a willingness to move to the sideline to more fully assess the evolving state of the U.S. economy and the impact of earlier policy initiatives. However, if June passes without further action, the question remains whether or not policy makers will reengage at a later date. Is this an indefinite pause before the eventual first rate cut? Or is the Fed simply skipping June to raise rates for the 11th time in July or shortly thereafter? While there are undoubtedly pockets of emerging weakness, the latest data suggest the latter is more likely. With inflation still elevated and an already tight labor market proving even tighter, there is clearly more work to be done. The challenge for the Fed will be to communicate a willingness to reengage after a temporary halt to rate hikes.

FED DIVIDED AMID SUPPORT FOR A PAUSE

After raising rates 10 times in 14 months at the fastest pace in more than 40 years, some Fed officials have indicated the need to take a breather and pause. According to Fed Governor Philip Jefferson and Philadelphia Fed President Patrick Harker, there is a need to take time to assess the incoming data in determining the appropriate longer-run pathway for policy. Of course, not all Fed officials are convinced the Committee can risk even a temporary stay in further tightening. According to Fed Governor Michelle Bowman and Cleveland Fed President Loretta Mester, there is not yet a compelling case to slow the trajectory of policy firming because inflation is still broadly elevated and high home prices, in particular, are complicating the Committee's efforts.



Source: Bureau of Labor Statistics/Haver Analytics: BLS, BLS/

Of course, while the June policy decision is far from solidified, even those Fed officials in favor of holding rates steady at 5.25% just five days from now broadly support further policy tightening later on. In other words, bypassing June is not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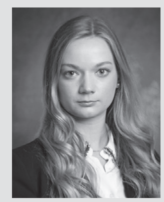
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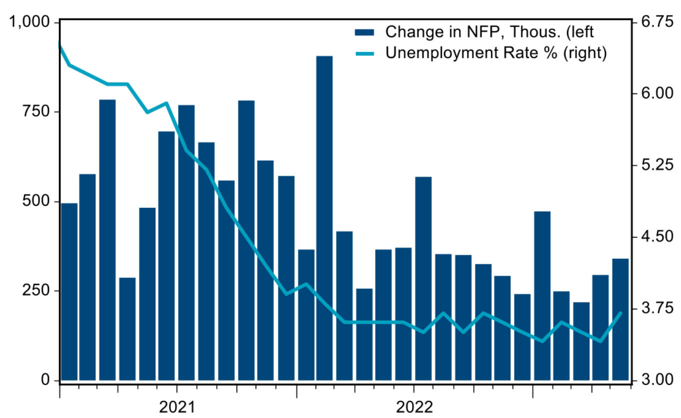
synonymous with expectations for a prolonged pause or an end to policy firming, but rather there is an expectation for the Committee to reengage sooner than later. While historically the Fed has faced challenges to resume hikes after ceasing action, given the lack of disinflation, if the Fed pauses in June, the Committee will likely tighten the following month.

"A decision to hold our policy rate constant at a coming meeting should not be interpreted to mean that we have reached the peak rate for this cycle."

- Fed Governor Philip Jefferson, Conference on Policy Challenges for the Financial Sector, May 31, 2023

UNEVEN DATA: TIGHT LABOR MARKET, ELEVATED INFLATION
As always, the evolution of the data will dictate the direction and momentum of policy in June and beyond as the Fed seeks to achieve its goal of full employment and stable prices. The latest May employment report, however, was somewhat of a mixed bag offering talking points for both the hawks and the doves on the Committee. After all, topline job creation jumped 339,000 in May, far surpassing market expectations and marking the largest monthly gain since January. Wages also continue to accelerate at a 4% pace as they have for nearly the past two years. On the other hand, painting a more muted picture of labor market metrics, the Household Survey reported a net loss of 310,000 payrolls, resulting in a surprisingly large jump in the unemployment rate from 3.4% to 3.7%.



Source: Bureau of Labor Statistics/Haver Analytic

Meanwhile, the latest inflation data continue to underscore the ongoing sticky nature of price pressures. Down from a recent peak in the first half of 2022, core Personal Consumption Expenditures (PCE) index, the Fed's preferred measure of inflation, remains more than double the Committee's target rate. Furthermore, shelter costs remain at a cycle peak, up 8.2% as of April with core services excluding housing, which is a proxy for the wage-price spiral, topping headline inflation growth at 5.0%.

The data rarely send a clean and cohesive message to policy makers. Nevertheless, the lack of meaningful progress in slowing price growth or reinstating balance to the labor market suggests there is a need for further policy firming. In fact, with the pace of disinflation painfully slow and a lingering – if not a growing – gap between labor demand and the supply of workers, the data arguably do not yet support the need for even a one-month skip, let alone an extended pause. Thus, any decision to – temporarily – move to the sideline next week will not be made because of the data, but rather in spite of the data.

POLICY DIRECTIVES
At this point, roughly 75% of market players are anticipating a stay in policy on June 14, suggesting the answer to the question "To pause or not to pause?" has widely been

GLOSSARY

CPI – Consumer Price Index

NFP – Nonfarm Payrolls

PCE – Personal Consumption Expenditures

YoY – Year over Year

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given. The outlook for July is much more divided. With a slight lean towards a restart in July over a second round pause at a 52%/34% split, investors are increasingly buying into the Fed's commitment to fight inflation and willingness to reengage. As recently as May 17, the market was anticipating the first rate cut potentially as early as July. Now, while the market still anticipates a reduction in the federal funds rate by year end, bets on the first rate cut have been pushed out to September.

While the unevenness in the labor market data, coupled with outright weakness in manufacturing and housing, somewhat strengthens the argument for a temporary pause, the Fed will not be willing to engage in an extended hold without a clear indication of a longer-term descent in inflation back to the Committee's 2% price target. Remember, even those Fed members in favor of a more cautious approach to policy have been clear in the distinction that any decision to skip a meeting would simply be an opportunity to more clearly gauge the state of the economy and more accurately measure the impact of earlier policy measures. A pause, however, is not a signal that the Fed has reached the terminal level of rates. Such a distinction will likely – and should – be articulated in the statement, if not by Fed Chairman Jerome Powell during next week's press conference.

The Committee may be nearing a point where rates could be held steady for longer. At this point, however, stopping short of slaying the inflation dragon would potentially do irreparable harm to the economy. Curtailing inflation-taming action too soon could allow inflation to become further entrenched and force the Fed to raise rates even higher than if the Committee kept its resolve to tame the inflation beast the first time around.

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