GENERALI INSURANCE ASSET MANAGEMENT

MARKET COMMENTARY

The Fed: high rates for much longer

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- **The expected pause in rate hikes had a distinctive hawkish flavour, as the dots point to another rate increase this year and, more importantly, a much flatter path of loosening in 2024, with only a 50bps reduction. The appropriate policy rate is expected to remain some 40bps above the long-term measure by 2026.**
- **The path for a soft landing has opened wide, according to the Fed, which has revised massively up the growth projections and expect the unprecedented degree of tightening to raise the unemployment rate only marginally. Therefore, the economy needs and can withstand higher rates for longer to tame inflation.**
- **At the same time, the hawkish bias helps the FOMC to keep all options open given the still large uncertainty on the economy and, by disappointing expectations of a quick loosening, should prevent an unwelcome loosening in financial conditions.**

With a decidedly hawkish twist, the Fed did not deliver any rate hike but signals that a strong economy and sticky inflation will require the policy rate to stay at extremely high level for much longer. Moreover 12 out of the 19 members flag the need for another rate hike this year. The median dots for 2024 and 2025 were both raised by 50 bps, so the Fed now envisages just 50bp cuts for next year (to 5.1%) with the policy rate ending 2026 at 2.9%, i.e. 40bps higher than the estimated neutral one. The GDP surprise for Q2 and the very positive indications for Q3 led to a massive upward revision (1pp) of the year end growth forecast. 2024 growth was revised upward too and the projection for the unemployment rate went down. The Fed paints an economy apparently immune to high rates, and, with the unemployment rate projected to peak at just 0.3pp higher than the current level, it feels capable to achieve a sort of "immaculate disinflation". Indeed, despite higher growth the inflation forecast was just marked to market for 2023 and left unchanged thereafter. The bullish reassessment of the growth outlook was duly reflected the press release (see comparison attached).

The messages that chair Powell tried to convey in the Q&A were basically two: i) if the economy and the labour market continue the trend seen over the last quarters, they can withstand the large rate increase needed to bring inflation back to 2%, therefore the path for a soft landing has widened; ii) having quickly reached the adequate level of restriction and given the uncertainty about the policy lags and that now the risks are two-sided, the FOMC must assess very careful the incoming data, therefore it needs to keep all options opened. This latter point can explain in part the hawkish tilt to the dots.

The solid pace of expansion and an historically low level of unemployment are coexisting, noted Powel, with a gradual rebalancing of the labour market. This is in large part due to a much stronger then expected health of households' balance sheets and a fast improvement in labour supply. Inflation is showing progress, very visible if, as suggested by Powell, one considers three- or six-month inflation. Still it is along way before getting to the target: the projections show the core rate reaching 2% only in 2026.

Concerning the conduct of monetary policy, decisions will continue to be taken meeting by meeting, Powell stressed, trying to downplay the strongly hawkish message delivered by the dots. Faced with an extreme uncertainty, FOMC members are inclined to keep a hawkish tilt, especially for the two remaining meetings of the year as an insurance against possible upside surprises on inflation or, as explicitly stated by Powell, if growth remains very strong. Another 25bps hike this year, would not matter much for the economy, Powell conceded, but may make the FOMC comfortable about having reached the adequate level of restriction. Afterwards, preventing inflation from spiking as the economy continues to growth healthily will require only a moderate dose of accommodation. Real rates are and will remain for a while above the mainstream estimates of the neutral interest rate, but whether the level of restriction is sufficient can only be gauged by looking at the effects on the economy. Quite unexpectedly, Powell decided to spend some time discussing a concept that he showed in the past not to like much: the neutral rate, he said, may have increased and this can explain the resilience of the economy and therefore the need for higher for longer rates. Powell also reiterated, not very convincingly, that the dots and the economic projections are not a plan, but just a cumulation of the individual projections by the FOMC members.

What was missing in the discussion was an analysis of financial conditions. The good news on the economy and expectations of the beginning of policy easing in H1 2024 have led to a loosening in asset prices-based measures of financial conditions, which runs counter the Fed's tightening effort. The very hawkish message delivered today is probably also meant to bring financial condition back to level consistent with the ongoing monetary policy tightening. The message seems to have gone though: at the end of the meeting the S&P was losing 0.9% as the 2-year Treasury yield soared to levels last seen in 2006 (5.17%).

We will reconsider our rate projections, but the strong determination of the Fed increases the probability of the sharp growth slowdown and subpar recovery we expect for the first half of 2024.

	2023	**2024**	**2025**	**2026**	**Longer run**
GDP growth (Q4/Q4 ann.)	2.1	1.5	1.8	1.8	1.8
Jun. projections	*1.0*	*1.1*	*1.8*		*1.8*
Unemployment rate	3.8	4.1	4.1	4.0	4.0
Jun. projections	*4.1*	*4.5*	*4.5*		*4.0*
PCE infl. (Q4/Q4 ann.)	3.3	2.5	2.2	2.0	2.0
Jun. projections	*3.2*	*2.5*	*2.1*		*2.0*
Core PCE infl. (Q4/Q4 ann.)	3.7	2.6	2.3	2.0	-
Jun. projections	*3.9*	*2.6*	*2.2*		-
Appropriate path for the policy rate					
Federal funds rate	5.6	5.1	3.9	2.9	2.5
Jun. projections	*5.6*	*4.6*	*3.4*		*2.5*

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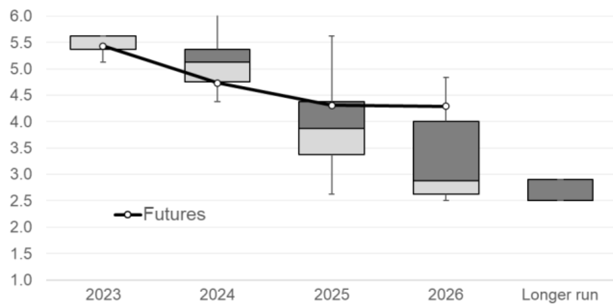
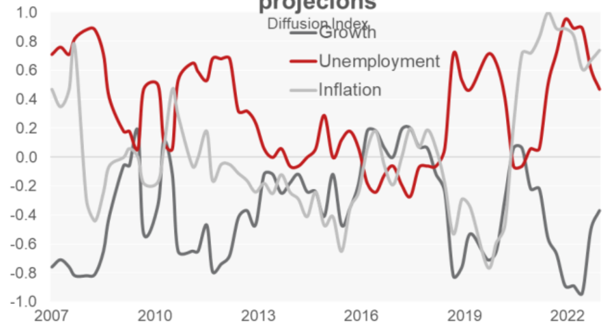


Source:Federal Reserve Board, Datastream,GIAM estimates



Source:Federal Reserve Board

Variable	Prev. FOMC meeting	Latest	Chg.
Real Activity			
Weekly activity index (yoy GDP)	1.0	1.9	0.9
ISM - Manuf	46.4	47.6	1.2
ISM - Services	52.7	54.5	1.8
Macro Surprises	68.2	57.5	-10.7
Labor Market			
Payroll growth (3 mth. MA)	201	181	-20
Unemp. Rate	3.6	3.8	0.2
Unemp. Rate (broad)	6.9	7.1	0.2
Hourly wages, % yoy (3 m. MA)	4.8	4.6	-0.2
Prices			
Core CPI	4.8	4.3	-0.5
Core PCE	4.1	4.2	0.1
Trimmed PCE	4.2	4.1	-0.1
U. Mich 5 yr exp.	3.0	3.0	0.0
NY Fed 3 Y exp.	2.9	2.8	-0.1
5Y5Y fwd exp.	2.5	2.5	0.0
Financial Conditions			
Chicago Fed index*	-0.3	-0.4	-0.1
10 yr. Treasury	3.9	4.4	0.5
- Risk neutral Component	4.6	4.6	0.0
- Term Premium	-0.7	-0.2	0.5
Yield curve (10Y - 3m)	-1.6	-1.1	0.5
S&P 500	4567	4444	-2.7%
Trade Wighted Dollar	127.6	131.3	2.8%
WTI Crude Oil	78.8	91.2	15.8%
* Decrease: looser conditions			

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