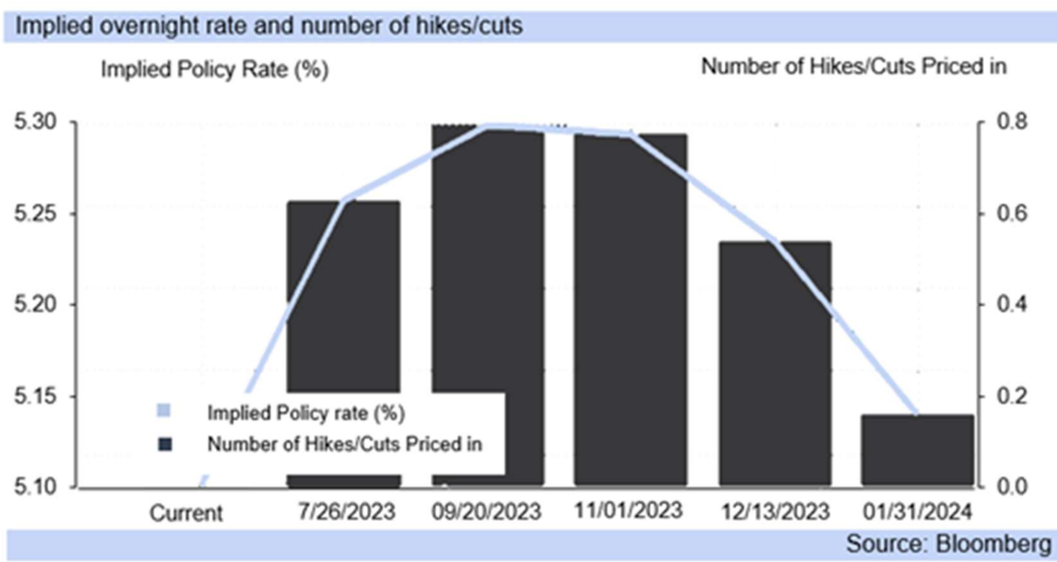
Investec

FOMC note: pause as expected, likely terminal rate (last interest rate hike) already reached

Thursday 15 June 2023

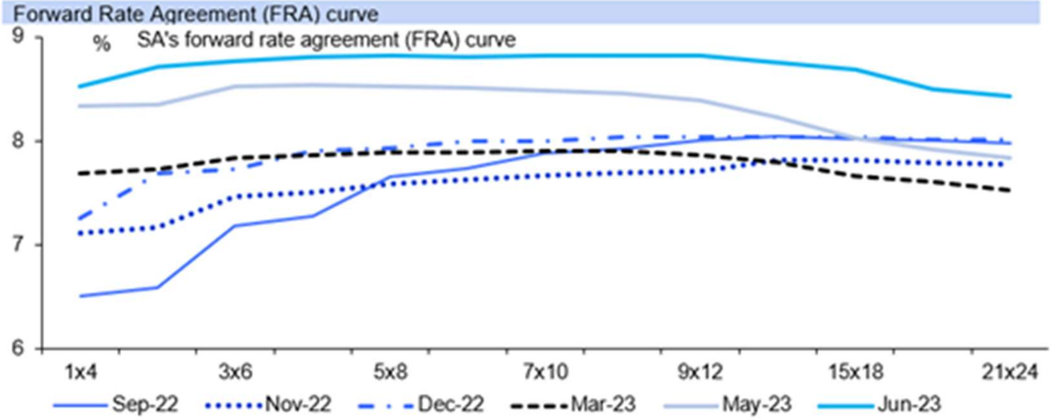


Fed Fund Futures implied rates – 15 June 2023					
Meeting	#Hikes/Cuts	% Hike/Cut	Implied Rate∆	Implied Rate	A.R.M
07/26/2023	+0.692	+69.2%	+0.173	5.253	0.250
09/20/2023	+0.872	+18.0%	+0.218	5.298	0.250
11/01/2023	+0.851	-2.1%	+0.213	5.292	0.250
12/13/2023	+0.589	-26.2%	+0.147	5.227	0.250
01/31/2024	+0.172	-41.7%	+0.043	5.123	0.250
					Source: Bloomberg

- The FOMC left the federal funds target rate unchanged (at 5.00% - 5.25%) as widely expected last night, to allow the "lags with which monetary policy affects economic activity and inflation, and economic and financial developments" to come through.
- That is, with a two to three quarter lag between a change in interest rates and the effect on the economy, including inflation, the rapid interest rate hike cycle in the US has not had time to fully feed through into inflation and other economic data.
- The unemployment rate in the US has only ticked up somewhat, and expectations are that the economic growth rate will slow, while both the consumer and producer price inflation rates are falling (disinflation is occurring).
- "Since early last year, the FOMC has significantly tightened the stance of monetary policy. We have raised our policy interest rate by 5 percentage points" but "the full effects of our tightening have yet to be felt."
- "In light of how far we have come in tightening policy, the uncertain lags with which monetary policy affects the economy, and potential headwinds from credit tightening, today we decided to leave our policy interest rate unchanged".
- "Committee participants generally expect subdued growth … the median projection has real GDP growth at 1.0 percent this year and 1.1 percent next year, well below the median estimate of the longer-run normal growth rate."
- The rand strengthened to R18.24/USD yesterday on US dollar weakness from a close of R18.63/USD, but has since moved back to R18.31/USD, with markets concerned that the FOMC is signalling further interest rate hikes could occur.
- In particular, Chair Powell said at the press conference that "(l)ooking ahead, nearly all Committee participants view it as likely that some further rate increases will be appropriate this year to bring inflation down to 2 percent over time".
- The FOMC next meets towards the end of July, and will deliver another interest rate decision on the 26th. Markets have factored in a 18bp hike at the meeting, and by September for rates to have risen by 21bp, not cumulatively (i.e. not 18bp + 21bp).
- Instead, if the FOMC hikes by 25bp at the July meeting it is essentially not expected to do the same again at the September meeting, but rather instead only deliver one more 25bp hike in total in the current interest rate cycle as per market expectations.

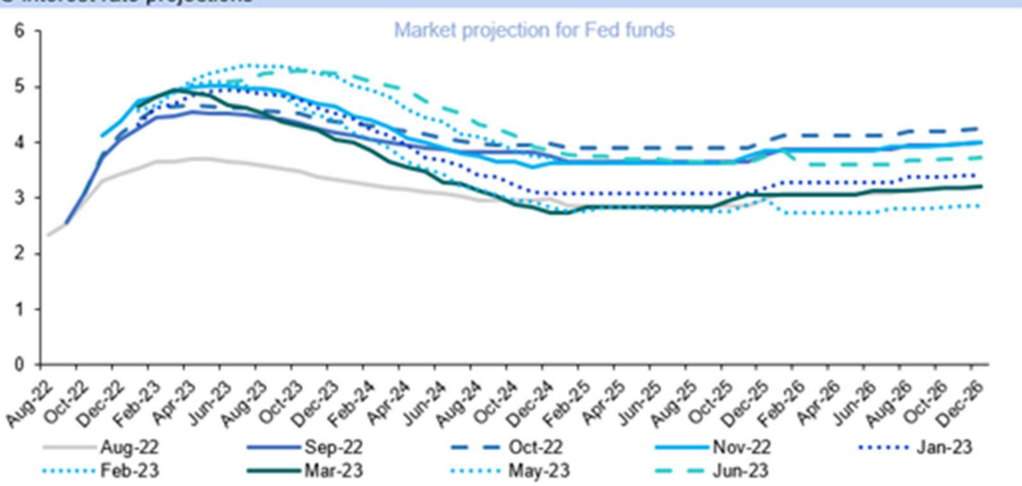
- However, it is likely that the FOMC will pause for longer then one meeting to assess the lagged effect of its interest rate hikes, given the two to three quarter lag noted above, and instead the Fed could keep interest rates flat out to Q4.23.
- Towards the end of this year markets (Fed funds implied futures) are currently factoring in the possibility of interest rate cuts, from November, although this is unlikely to occur so soon, and the FOMC is more likely to wait until January.
- While events can change in the next six months, economic data coming out in the US is likely to pull market sentiment closer to that of no further hikes in the US interest rate cycle, allowing the terminal (end) rate to have been reached already in May.
- South Africa's FRAs have currently only fully priced in a 25bp hike in SA's repo rate by September, and then a flat trajectory thereafter, but as US interest rate hike expectations work out of the system this is likely to fall away too.

Forward Rate Agreement (FRA) curve



Source: Bloomberg

US interest rate projections



Source: FOMC, Bloomberg