US Daily: May FOMC Preview: Signaling a June Pause (Mericle)

- The FOMC is likely to deliver a widely expected 25bp rate hike to 5-5.25% at its May meeting, but the focus will be on revisions to the forward guidance in its statement. We expect the Committee to signal that it anticipates pausing in June but retains a hawkish bias, stopping earlier than it initially envisioned because bank stress is likely to cause a tightening of credit.
- For example, the FOMC might borrow language from a statement at a similar juncture in a prior cycle and say something like, "The Committee anticipates that the stance of monetary policy will most likely be sufficiently restrictive to return inflation to 2 percent over time but will closely monitor incoming information and assess the implications for monetary policy. In determining the extent and timing of any additional increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."
- Beyond May, we expect the FOMC to hold rates steady for the rest of the year, though several paths are possible, with much depending on how severely the bank stress affects the economy. Our probability-weighted average Fed forecast is somewhat higher than market pricing, reflecting both our below-consensus recession probability and our view that the threshold for rate cuts is likely to prove higher than some investors expect.

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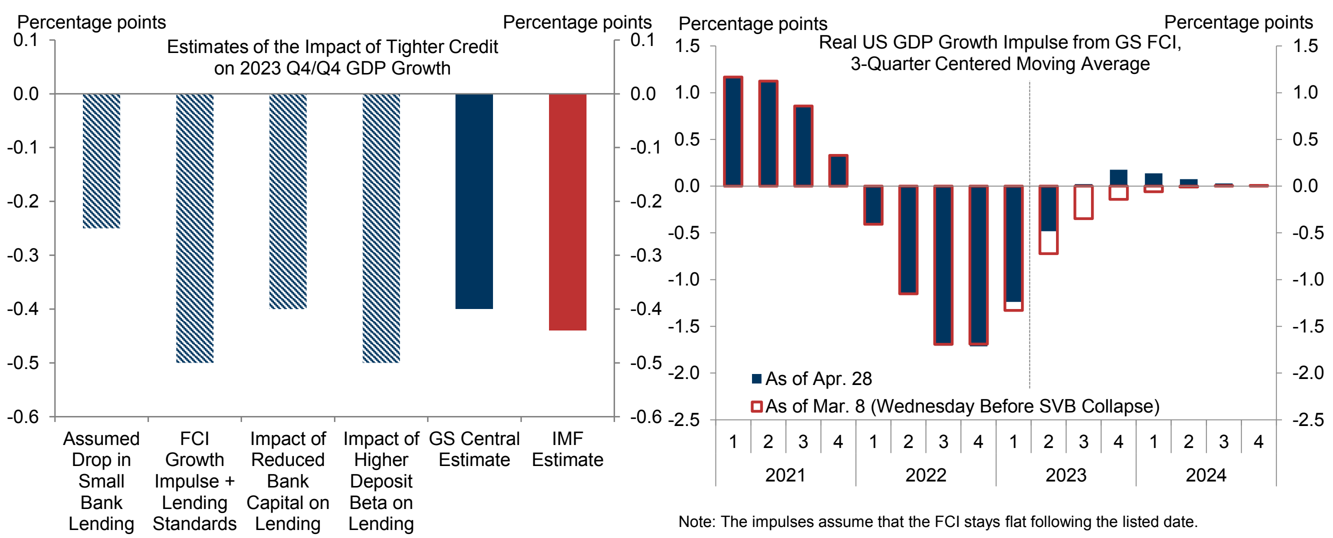
May FOMC Preview: Signaling a June Pause

The FOMC is likely to deliver a widely expected 25bp hike at its May meeting, raising the target range for the funds rate to 5-5.25%. But the focus will be on revisions to the forward guidance in the post-meeting statement, and specifically whether the FOMC signals that it expects to pause in June.

We expect the Committee to signal that it does anticipate a June pause. This would mean stopping earlier than most FOMC participants likely envisioned before the recent bank stress on the grounds that tighter credit can substitute for rate hikes in restraining demand and that there is still considerable uncertainty about the eventual impact. The downside risks were highlighted by the Fed staff's March forecast that tighter credit is likely to push the economy into a mild recession this year.

Our central estimate is that tighter credit is likely to slow growth in 2023 by about 0.4pp (Exhibit 1, left), equivalent to the usual impact of 40bp of rate hikes. So far, we interpret data on bank lending standards and bank lending volumes since the start of the banking turmoil as roughly consistent with the assumptions that underlie our estimates. It is still too soon to have much confidence, and in principle the easing in market-based financial conditions since the start of the banking turmoil could partly offset its impact (Exhibit 1, right). But we think that recent data, especially comments about tighter lending standards in the Fed's Beige Book, legitimize these concerns enough for a June pause.

Exhibit 1: Our Central Estimate Is That Tighter Credit Will Reduce 2023 Q4/Q4 GDP Growth by 0.4pp, Though the Drag from Market-Based Financial Conditions Has Diminished by Almost as Much



Source: Goldman Sachs Global Investment Research

The FOMC will likely balance a nod toward a June pause with a clear message that it retains a hawkish bias and a reminder that it is, as always, open to reconsidering on the basis of new information. The appendix summarizes language that the FOMC has used at similar junctures in past cycles and includes an example from 2006—when it said that "any additional firming" of the policy stance would depend on how the outlook evolves—that could be appropriate this week. Exhibit 2 offers an example of how the

FOMC might balance an expected June pause, a continued hawkish bias, and data dependence.

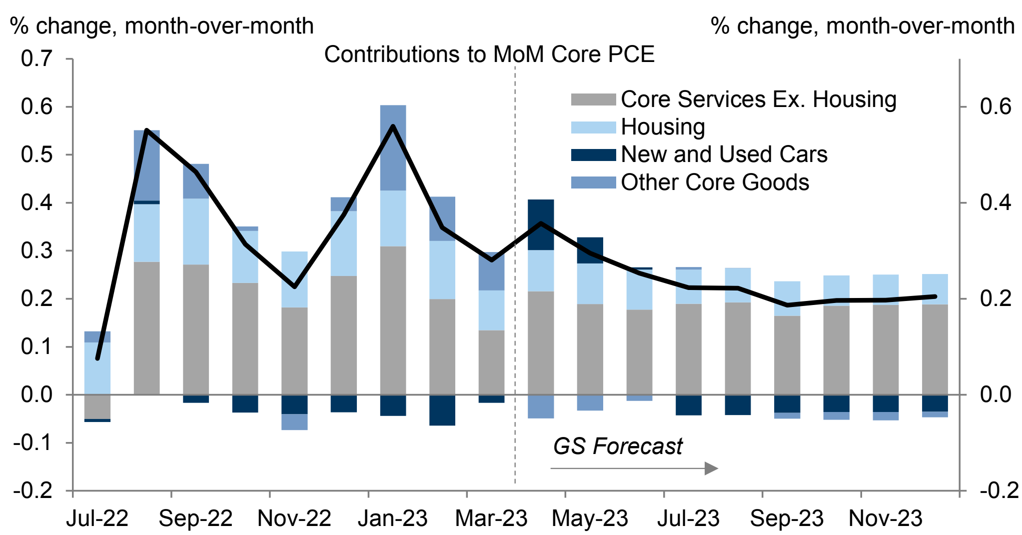
Exhibit 2: We Expect the FOMC to Indicate That It Expects to Pause in June but Retains a Hawkish Bias

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 5~~4-3/4~~ to 5-1/4 percent. ~~The Committee will closely monitor incoming information and assess the implications for monetary policy.~~ The Committee anticipates that ~~some additional policy firming may be appropriate in order to attain a~~the stance of monetary policy ~~that~~ will most likely be~~is~~ sufficiently restrictive to return inflation to 2 percent over time but will closely monitor incoming information and assess the implications for monetary policy. In determining the extent and timing of any additional ~~future~~ increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments.

Source: Federal Reserve Board, Goldman Sachs Global Investment Research

A hawkish alternative would be to offer neutral guidance by saying that future decisions will depend on incoming data. But this might lead the market to price a higher probability of a June hike than the FOMC would like and could prove awkward if, as we expect, core CPI inflation rises to around 50bp in April because of a large jump in used car prices (Exhibit 3) that would have little lasting importance. If the market responded by inferring that a high inflation print made a hike very likely, the FOMC might find itself boxed in.

Exhibit 3: We Expect Core Inflation to Rise in April and May on a Bounce in Used Car Prices, but Then Trend Lower

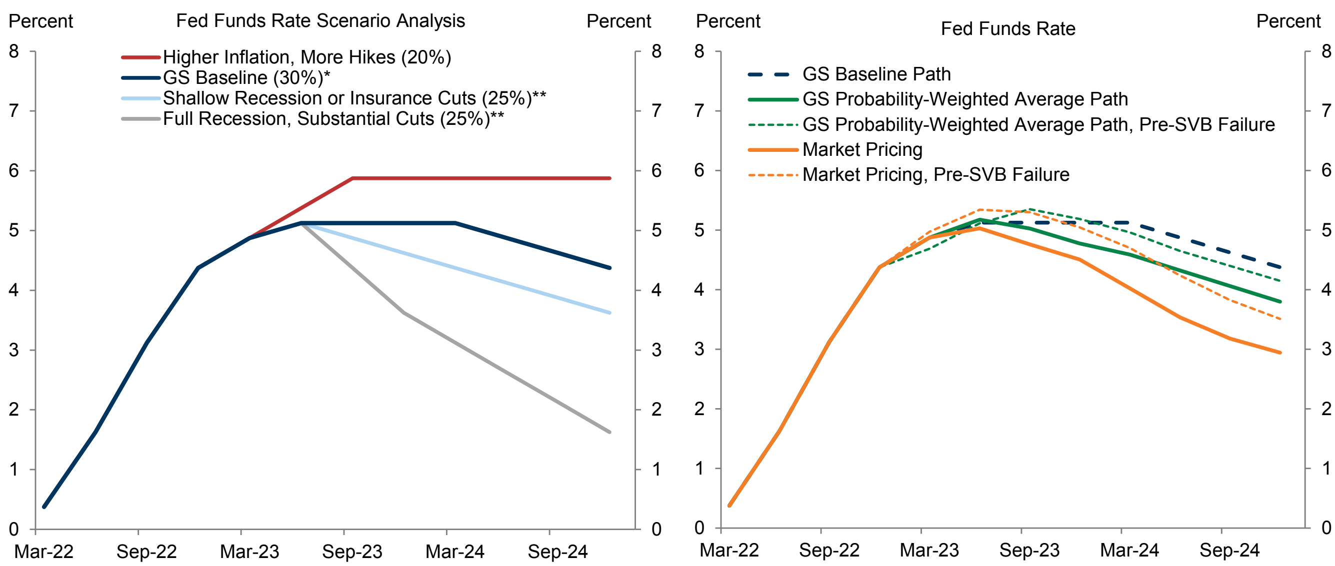


Source: Goldman Sachs Global Investment Research

Beyond May, we expect the FOMC to hold rates steady for the rest of the year, though several paths are possible, with much depending on how severely the banking stress affects the economy. To the upside, strong growth of domestic final sales in Q1 highlighted the reacceleration risk that was our main concern earlier this year, and if the impact of the bank stress proves modest, then additional 25bp rate hikes would be possible. To the downside, we see some risk that the impact of tighter credit could exceed our central estimate, especially if it hits especially hard in sections of the economy that are most dependent on small and midsize banks, such as real estate and manufacturing and small businesses in small towns.

Exhibit 4 shows that our probability-weighted average Fed forecast (in green on the right) is somewhat higher than market pricing (in orange on the right), especially in 2024. The most obvious reason for this is our below-consensus recession probability of 35% over the next 12 months (vs. 65% consensus). A second reason is that we expect the threshold for rate cuts to prove higher than some investors expect. Our best guess is that the Fed will wait until a growth scare emerges to cut rather than cutting anytime soon solely because inflation has come part way down, though we softened our stance on that a bit last month and could also imagine a combination of a convincing decline in inflation and a desire to reduce pressure on banks from a deeply inverted yield curve adding up to a reason to lower the funds rate.

Exhibit 4: Our Probability-Weighted Fed Forecast Is Somewhat Higher Than Market Pricing, Reflecting Both Our Below-Consensus Probability of Recession and Higher Expected Threshold for Cuts



* The cuts in our baseline scenario are meant as a placeholder for an uncertain future date when a material risk to growth emerges.
** The recession scenarios show unrealistically slow cuts to capture many sub-scenarios of recessions starting at various points in time. The recession scenarios reflect our subjective recession probability of 35% over the next 12 months and continued elevated risks thereafter.

Source: Goldman Sachs Global Investment Research

David Mericle

Exhibit 5: Appendix: Dovish, Neutral, and Hawkish Language from Past FOMC Statements at Similar Junctures

Changes to FOMC Communications Ahead of Meetings in Which It Paused, Ended, or Anticipated Ending Tightening Cycles*

Key Quote(s)	Source
The Federal Reserve will continue to monitor economic and financial developments to gauge the appropriate stance of policy. But these actions are expected to be sufficient, at least for a time, to meet the objective of sustained, noninflationary growth.	FOMC Statement, Aug-94
Today's increase in the federal funds rate, together with the policy actions in June and August and the firming of conditions more generally in U.S. financial markets over the course of the year, should markedly diminish the risk of inflation going forward. As a consequence, the directive the Federal Open Market Committee adopted is symmetrical with regard to the outlook for policy over the near term.	FOMC Statement, Nov-99
Against the background of its long-term goals of price stability and sustainable economic growth and of the information ~~currently~~ already available, the Committee believes the risks are weighted mainly toward conditions that may generate heightened inflation pressures in the foreseeable future.	FOMC Statement, May-00
~~The Committee judges that further policy firming may yet be needed to address inflation risks but emphasizes that the~~ The extent and timing of any ~~such firming~~additional firming that may be needed to address these risks will depend ~~importantly~~ on the evolution of the outlook for both inflation and economic ~~outlook~~growth.	FOMC Statement, Jun-06
The Committee judges that some further gradual increases in the target range for the federal funds rate will most likely be consistent with [the FOMC's policy objectives].	FOMC Minutes, Dec-18

* For FOMC statements, additions relative to the prior statement are underlined and deletions are struck through.

Source: Federal Reserve Board, Goldman Sachs Global Investment Research

Disclosure Appendix

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We, Jan Hatzius, Alec Phillips, David Mericle, Spencer Hill, CFA, Joseph Briggs, Ronnie Walker, Tim Krupa and Manuel Abecasis, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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