US Daily: July FOMC Preview: The Last Hike (Mericle)

- A 25bp rate hike is fully priced for the July FOMC meeting next week. The key question is how strongly Chair Powell will nod toward the "careful pace" of tightening he advocated in June, which we and others have taken to imply an every-other-meeting approach. We expect Powell to cautiously avoid implying that the FOMC has already reached an agreement but are confident that he does want to slow the pace and that the FOMC will end up skipping in September.
- Incoming information during the intermeeting period has had mixed implications for Fed policy. On the dovish side, core CPI inflation slowed sharply in June in what we think will prove to be a turning point in the inflation story. On the hawkish side, activity data continued to show that demand growth ran above potential in 2023H1, and financial conditions eased a bit further.
- We expect a hike next week to 5.25-5.5% to be the last of the cycle. But on a probability-weighted basis, our Fed views remain more hawkish than market pricing. This reflects both our lower probability of recession and our expectations that the threshold for rate cuts will be fairly high and that cuts will be gradual. We expect cuts to start in 2024Q2, to proceed at 25bp per quarter, and to end with the funds rate at 3-3.25%, above the FOMC's 2.5% longer run dot.

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July FOMC Preview: The Last Hike

A 25bp rate hike to 5.25-5.5% is fully priced for the July FOMC meeting next week and widely expected by forecasters and investors.

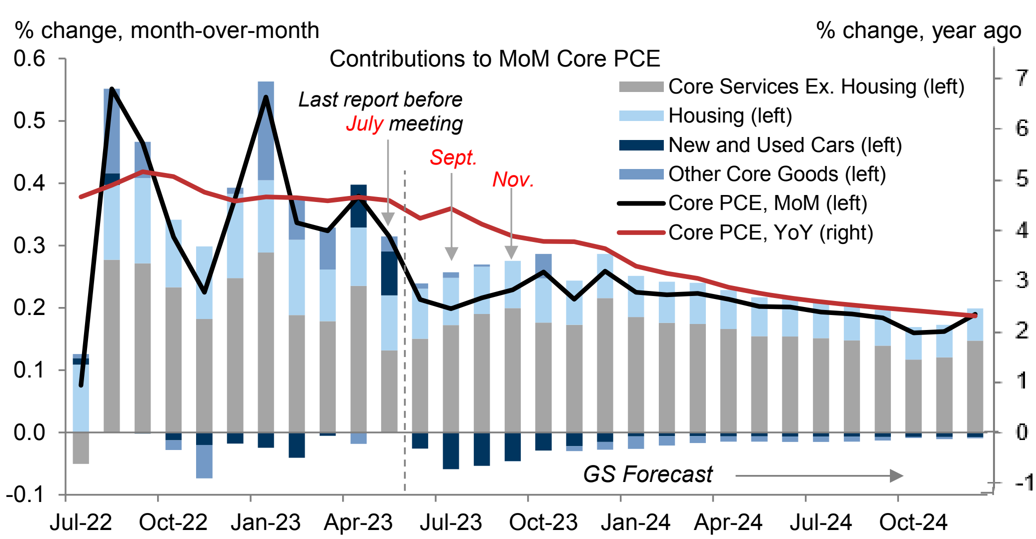
The key question is how strongly Chair Powell will nod toward the "careful pace" of tightening he advocated in June. His earlier comments led us and many other market participants to infer that he prefers to move to an every-other-meeting pace, which would imply skipping a rate hike in September.

The minutes to the June meeting noted that "many" but not quite a majority of participants signed on to moderating the pace, and some more hawkish participants have since made it clear that they are not yet persuaded, as our FOMC Chatterbox notes. As a result, we do not expect the FOMC statement to signal a slower pace, and we expect Powell to be cautious to avoid implying that the FOMC has already reached a formal agreement. Nevertheless, we are confident that he does want to slow the pace and that, with lower inflation data in hand, a majority will ultimately sign on to skipping September.

Incoming information during the intermeeting period has had mixed implications for Fed policy.

On the dovish side, core CPI inflation slowed sharply in June in what we think will prove to be a turning point in the inflation story. Powell emphasized that core inflation had been stubbornly high at the June meeting and that this was the key reason that most FOMC participants expected at least two more rate hikes. By the November meeting, we expect that the core inflation trend will have taken a decisive step down (Exhibit 1) and that this will convince the FOMC that a second hike is unnecessary.

Exhibit 1: Core CPI Inflation Stepped Down in June in What We Think Will Prove to Be a Turning Point

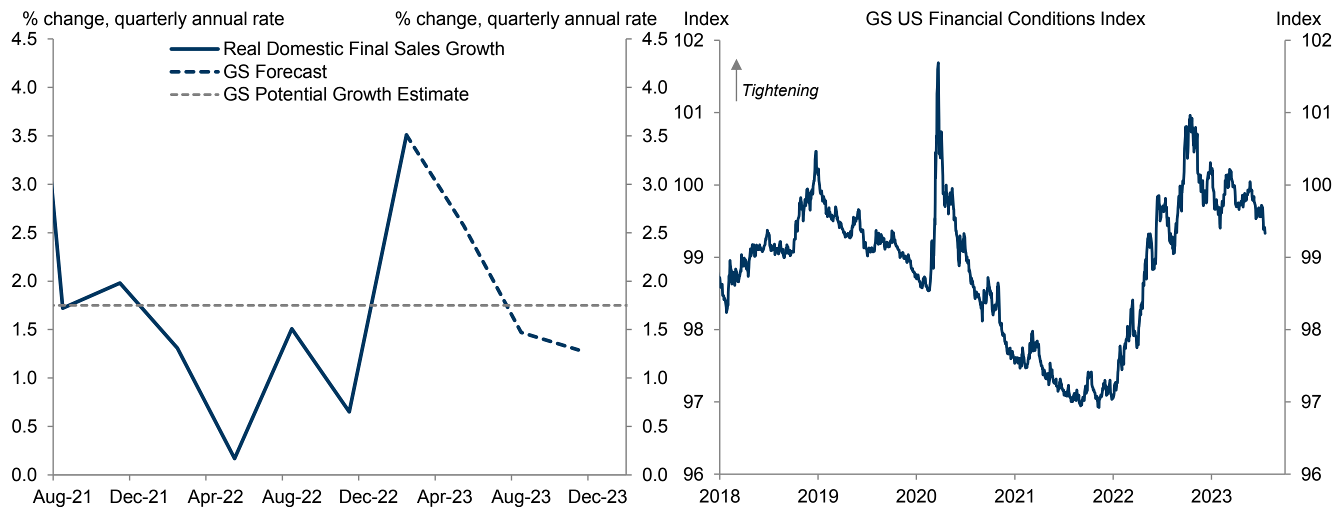


Source: Department of Labor, Goldman Sachs Global Investment Research

On the hawkish side, activity data continued to show that the economy reaccelerated in

2023H1 to an above-potential growth pace (Exhibit 2, left), and financial conditions continued to ease a bit further (Exhibit 2, right). This is not what the FOMC planned for 2023, but the Fed leadership can afford to overlook it for now because labor market rebalancing has nevertheless continued and is now most of the way to the finish line, there is a substantial amount of disinflation already in the pipeline that should come through regardless, and GDP growth is likely to slow in the back half of the year.

Exhibit 2: Demand Reaccelerated in the First Half of 2023, and Financial Conditions Have Continued to Ease



Source: Department of Commerce, Goldman Sachs Global Investment Research

We expect a hike next week to be the last of the cycle. But on a probability-weighted basis, our Fed views remain more hawkish than market pricing (the green line on the right of Exhibit 3 is less inverted than the orange line). This reflects both our relatively low estimate of the probability of recession and our expectations that the threshold for rate cuts will be fairly high and that cuts will be gradual.

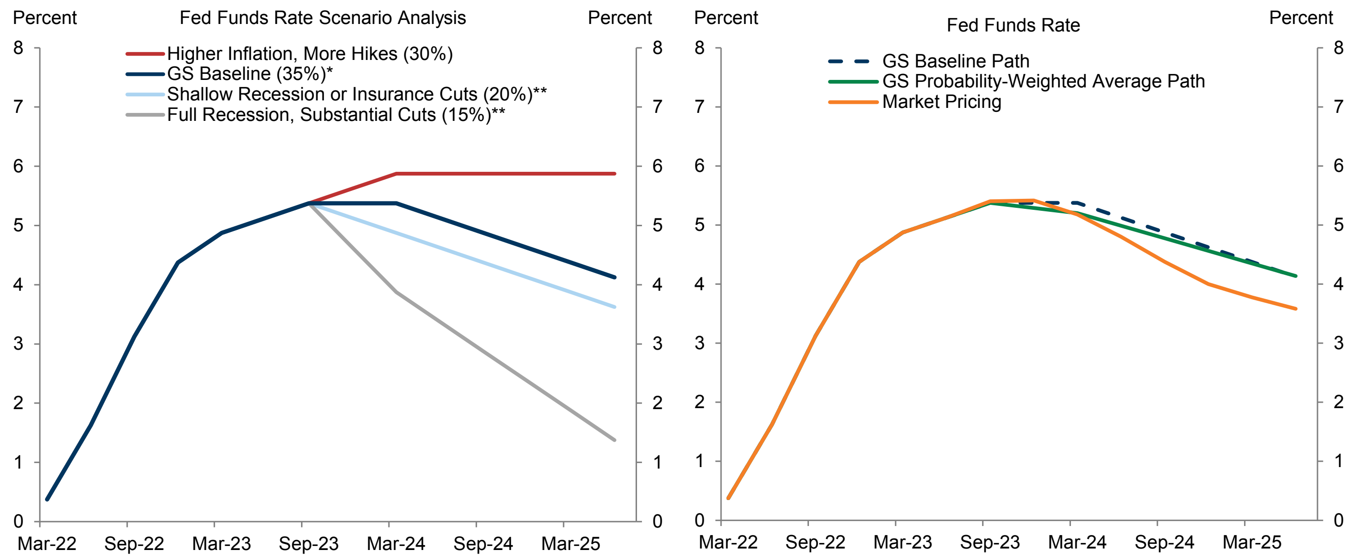
We conclude with a few more specific thoughts on rate cuts.

On the start date, we expect the first cut to come in 2024Q2. We have long envisioned a fairly high threshold for cuts, with the FOMC waiting until either some risk to growth emerges or until inflation falls convincingly. In our forecast, the first cut comes when core PCE has fallen below 3% on a year-on-year basis and below 2.5% on a monthly annualized basis. We see some possibility that even then, the FOMC might not cut. If growth is above potential, the unemployment rate is reaching new half-century lows, and financial conditions have eased further, cutting might feel like an unnecessary risk. We put a meaningful amount of probability weight on a no-cuts scenario (the red line on the left of Exhibit 3).

On the pace, we expect cuts to proceed at 25bp per quarter. Once inflation is close to target, the motivation for cutting absent a recession would be to slowly gravitate back toward neutral. Cuts would be the mirror image of rate hikes last cycle, when the FOMC was similarly hiking not to solve any urgent problem but to slowly return to neutral, and we think that moving at the same pace would make sense.

On the terminal or equilibrium rate, we expect the funds rate to ultimately stabilize at 3-3.25%, above the FOMC's 2.5% median longer run dot. Our forecast is slightly higher both because we think neutral is higher than the FOMC's estimate and because this time the funds rate is approaching from above rather than from below and might end up a bit higher if the FOMC stops once it is "close enough" to its targets.

Exhibit 3: Our Fed Views Remain More Hawkish Than Market Pricing on a Probability-Weighted Basis



* 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 20% over the next 12 months and modestly elevated risk in the following year.

Source: Goldman Sachs Global Investment Research

David Mericle

Disclosure Appendix

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We, Jan Hatzius, Alec Phillips, David Mericle, Spencer Hill, CFA, 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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