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Friday Finish – US Economics | North America

Channeling the Fed

MORGAN STANLEY & CO. LLC
Ellen Zentner
CHIEF US ECONOMIST
Ellen.Zentner@morganstanley.com +1 212 296-4882

The data are in and support a final 25bp rate hike at the Fed's May meeting. After going on hold, the timing, magnitude, and direction of the next move will remain an open question, but the Fed has experience crafting language to convey this. I illustrate what it might say.

From the desk of the Chief US Economist

My Friday Finish dated March 24 asked, "Do the Data Matter Now?". My team knows I generally dislike asking a question in the title, likely because an influential colleague early in my career told me the answer is always no. So perhaps that's why I was willing to ask the question because the answer then, and now, is yes. But I must clarify that the data matter only insofar as banking pressures are stable and credit conditions remain healthy. So against a backdrop of relative stability in the financial system, we believe the employment and inflation data in hand will lead the Fed to deliver a final 25bp hike at the May 2-3 meeting.

Governor Waller delivered a speech in San Antonio, Texas this morning that I think lays out the policy considerations for the May meeting, and beyond, quite well – even though Waller is a sample size of one versus an 18-person Committee.

"Another implication from my outlook and the slow progress lately is that, as of now, **monetary policy will need to remain tight for a substantial period of time, and longer than markets anticipate.** But there are still more than two weeks until the next FOMC meeting, and I stand ready to adjust my stance based on what we learn about the economy, including about lending conditions. Other data such as those on the housing sector, personal income, and surveys that provide managers' views of economic conditions in April will come in over the next few weeks. **I would welcome signs of moderating demand, but until they appear and I see inflation moving meaningfully and persistently down toward our 2 percent target, I believe there is still work to do."** [Emphasis added.]

In reaction to his speech, market pricing of the rates path pushed the probability of a 25bp hike at the May meeting to all but certain and lifted the probability of a June hike from negligible to ~15%. Pricing of cuts later this year remains sticky, with the expected December 2023 level of the federal funds rate little changed over the past two weeks. The Fed is prepared to move based on what it learns about the economy and lending conditions and so will market pricing, so these probabilities are far from set in stone.

How might the Fed craft a message that both suggests it may have done enough but is also open to making further adjustments – in either direction – if necessary? Below, I offer illustrations of how the message might be crafted along the lines of *the December 2015 and 2018 statements.*

In the spirit of the December 2015 statement:

The federal funds rate is likely to remain above levels that are expected to prevail in the longer run for a substantial/considerable/extended period of time *(emphasis added). However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data on the economy and lending conditions.*

In the spirit of the December 2018 statement:

In determining the timing and size of future adjustments to the target range for the federal funds rate *(emphasis added), the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.*

Leading up to the June meeting, we think further slowing in employment and core inflation, alongside the judgment that cumulative effects of past policy actions and tighter credit means policy is sufficiently in restrictive territory, and will keep the Fed comfortable with holding rates steady. **Our preliminary forecast for May job gains at 136k and core CPI at 0.25M we think extends the evidence of slowing momentum, and policymakers will be able to extrapolate from recent trends.**

What if May is not the beginning of the pause? More resilience in the labor market could put another hike in June on the table. Exhibit 1 shows our illustrative roadmap for near-term policy decisions. Stronger data and fewer signs of deceleration would have to be weighed against incoming information on bank lending and its economic effects. The Fed has shifted back to a more anticipatory approach to policy and is now more likely to look through near-term data strength than before if the economic outlook darkens more than anticipated.

Enjoy your weekend.

Exhibit 1: Our Roadmap to the June Policy Decision

%M	Headline PCE	Core PCE	Headline CPI	Core CPI	Nominal Consumption	Real Consumption	NFP	UR	Assessment:
Jul-22	-0.12	0.04	-0.02	0.31	-0.20	-0.11	568	3.5	
Aug-22	0.29	0.56	0.12	0.57	0.87	0.60	352	3.7	
Sep-22	0.42	0.54	0.39	0.58	0.63	0.28	350	3.5	
Oct-22	0.42	0.31	0.49	0.33	0.62	0.20	324	3.7	
Nov-22	0.17	0.22	0.21	0.31	-0.33	-0.50	290	3.6	
Dec-22	0.20	0.37	0.13	0.40	0.12	-0.08	239	3.5	
Jan-23	0.57	0.52	0.52	0.41	2.28	1.69	472	3.4	
Feb-23	0.26	0.30	0.37	0.45	0.15	-0.11	326	3.6	
Mar-23	**0.12**	**0.33**	0.05	0.38	**-0.13**	**-0.41**	236	3.5	May FOMC: 25bp expected.
Apr-23	**0.46**	**0.44**	**0.44**	**0.40**	**0.21**	**-0.12**	**186**	**3.5**	
May-23	**0.18**	**0.34**	**0.09**	**0.30**	**0.18**	**0.08**	**136**	**3.5**	June FOMC: 0bp expected. NFP>150k & Core CPI> 0.35 -- 25bps
Jun-23	**0.30**	**0.29**	**0.28**	**0.26**	**0.18**	**-0.05**	**86**	**3.6**	

Source: BLS, BEA, Morgan Stanley Research forecasts

Incorporating data on CPI and retail sales this week moved our GDP tracking for 1Q23 down to 1.2% Q/Q annualized growth vs. 1.6% last week.

Data I'm watching next week: Key Data Watch Calendar.

Housing Starts (Tuesday, 8:30am): We forecast housing starts declined 5.7%M to a 1,367.5k unit pace. Single-family starts are expected to stay flat while multi-family starts are expected to significantly decline.

Leading Indicators (Thursday, 10:00am): We forecast the Leading Index to fall by 1.2%M in March, down from its prior reading. This follows negative contributions from a decline in ISM activity, consumer confidence, higher jobless claims, lower equity prices, and higher interest rates.

Weekend Reading/Listening:

- US Economics: Retail Sales: Into the Decline (14 Apr 2023)
- Global Economics: Global Inflation Monitor (14 Apr 2023)
- US Economics: Business Conditions: Credit Conditions Slump (13 Apr 2023)
- US Economics: FOMC Minutes: A March 8 Delineation (12 Apr 2023)
- Global Economics: Global Central Bank Monitor (11 Apr 2023)
- Podcast | Thoughts on the Market: Ellen Zentner: The Lagging Effects of Loan Growth (10 Apr 2023)
- Global Economic Briefing: The Weekly Worldview: Spring Break Reads (10 Apr 2023)

Past Friday Finish Commentary:

- Friday Finish – US Economics: The Substitution Effect (31 Mar 2023)
- Friday Finish – US Economics: Do the Data Matter Now? (24 Mar 2023)
- Friday Finish – US Economics: Fluid and Uncertain (17 Mar 2023)
- Friday Finish – US Economics: Lags and Nonlinearity (11 Mar 2023)
- Friday Finish – US Economics: Not That Much Higher, but For Longer (3 Mar 2023)
- Friday Finish – US Economics: Survey Says! "Manufacturing Stabilizing" (24 Feb 2023)

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