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US Economics | North America

Adding a July Hike

We now judge that the bar for a July hike is significantly lower than we had initially expected and have added a 25bp hike to our policy path. The revision is a level shift upward to 5.375% fed funds end-23, and 4.375% end-24. We continue to see a soft landing staving off rate cuts to next year.

As we expected, the Fed hit the pause button at the June FOMC meeting and we declared the hiking cycle over at a peak rate of 5.1%. Chair Powell emphasized the need to see more data to gauge the appropriate policy path thereafter, and given that there are only two relevant data prints (nonfarm payrolls and CPI) between the June and July meetings, it made sense to assume no hikes in July as the Fed digests more data. Our roadmap, an illustrative exercise built around our high-frequency forecasts for jobs and inflation, as well as our perceived Fed reaction function, also suggested the Fed was done.

The bar to a July hike is now lower. What changed? During his testimony before Congress last week, Chair Powell made several remarks hinting that the Fed is reducing the pace while it approaches the appropriate level of monetary tightening. He stated that “it may make sense to move rates higher, but to do so at a more moderate pace”, and that “people on the Committee do believe that it will be appropriate to raise rates one or two additional times.” Powell also made clear he was among those on the Committee that feel strongly rates should be higher.

We now think the Fed will hike in July - our data forecasts have not changed, but our perception of the Fed's reaction function now points to a significantly lower bar to hike. In other words, we would need very weak data prints to convince the FOMC that its forecasts are wrong by the July meeting. [Exhibit 1](#) details our high-frequency forecasts and the Fed's likely reaction. We think that a nonfarm payroll print below 100k and core services CPI below 0.2%MoM would lead the Fed to remain on pause, well below our current forecasts.

Exhibit 1: A low bar for a hike in July, but a much higher one further out

%M	Core PCE	Core PCE 3M AR	Core CPI	Core CPI 3M AR	Core Core Services*	Core Core Services 3M AR	Core Services	Core Services 3M AR	NFP	3M MA NFP	Assessment:
Dec-22	0.37	3.71	0.40	4.25	0.40	6.00	0.61	6.62	239	284	
Jan-23	0.55	4.69	0.41	4.58	0.72	6.65	0.55	6.79	472	334	
Feb-23	0.35	5.23	0.45	5.17	0.91	8.44	0.62	7.34	248	320	
Mar-23	0.31	4.96	0.38	5.11	0.71	9.78	0.45	6.66	217	312	
Apr-23	0.38	4.25	0.41	5.10	0.20	7.54	0.36	5.87	294	253	
May-23	0.35	4.24	0.44	5.03	0.34	5.10	0.40	4.92	339	283	June FOMC: 0bp delivered.
Jun-23	0.23	3.92	0.27	4.56	0.30	3.39	0.34	4.47	270	301	July FOMC: 25bp expected. NFP<100k & Core Services < 0.2 - 0bps
Jul-23	0.21	3.22	0.21	3.73	0.29	3.76	0.33	4.34	185	265	
Aug-23	0.17	2.49	0.17	2.63	0.32	3.67	0.33	4.06	170	208	Sep FOMC: 0bp expected. NFP>200k & Core Services > 0.55 -25bps
Sep-23	0.15	2.17	0.15	2.11	0.35	3.88	0.33	4.02	150	168	Oct FOMC: 0bp expected. NFP>220k & Core Services > 0.65 -25bps
Oct-23	0.15	1.94	0.20	2.07	0.35	4.12	0.40	4.32	90	137	
Nov-23	0.15	1.84	0.19	2.18	0.34	4.22	0.39	4.57	80	107	
Dec-23	0.14	1.80	0.19	2.34	0.33	4.14	0.38	4.76	60	77	

* Core core services: Core CPI ex. Medical & Housing. Bold numbers are MS forecasts.

Note: The assessment for each meeting assumes we are correct on the Fed's action in the prior meetings. Source: BLS, Morgan Stanley Research forecasts

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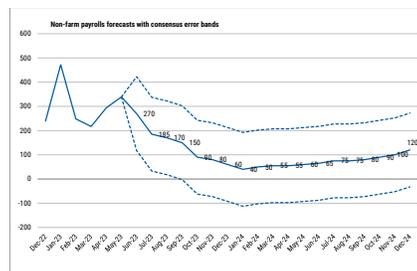
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Hikes beyond July are data dependent, and the Fed's own inflation forecast revision has lowered the bar to pause for an extended period. In the June Summary of Projections (SEP), the median forecast for core PCE inflation was revised 0.3pp higher to 3.9% Q4/Q4 (vs MS: 3.4%) and real GDP growth 0.6pp higher to 1.0% Q4/Q4 (vs MS: 0.4%) for 2023. In his testimony, Chair Powell continued to stress data dependency, clarifying that the Fed would hike as long as the economy performs as expected. Hence, data prints pointing to growth and inflation lower than the Fed's expectations might erase future hikes.

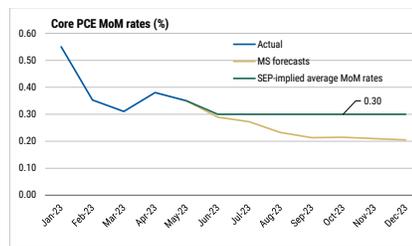
We think that incoming data will force a change in the September FOMC projections and the Fed will hold rates at a peak of 5.375%. We forecast a downward path for nonfarm payrolls and, given how volatile the series is, August/September could even mark the **first negative payroll print**. Adding consensus error bands around our forecasts, **Exhibit 2** shows that August is on the line and September is the first time it moves into negative territory. Moreover, on the inflation front, we expect core PCE sequential prints below the average 0.3%MoM implied by the 3.9%(Q4/Q4) forecast in the SEP (**Exhibit 3**).

Exhibit 2: We expect weaker payroll prints ahead...



Note: Error bands are +/- two consensus forecast error standard deviations. Standard deviations calculated using 2010-2019.
Source: BLS, Bloomberg, Morgan Stanley Research forecasts

Exhibit 3: ...and core PCE sequential inflation below SEP-implied rates



Source: Fed, BLS, Morgan Stanley Research forecasts

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