1 February 2023

Research US

Fed Review – Powell sees a higher chance of a soft landing

- **Fed hiked rates by 25bp as widely expected. Powell saw probability of soft landing increasing, as inflation has eased without the economy slowing markedly.**
- **The persistently tight labour and the turnaround in global manufacturing cycle leave Fed little room to turn more dovish. We still expect 2x25bp hikes in the March and May meetings.**
- **Markets reacted dovishly, with USD selling off and UST yields falling. We stick to our forecast of lower EUR/USD at 1.07 in 3M.**

Powell appeared more optimistic about inflation coming down without Fed having to force the economy into a deep recession, which sparked a dovish reaction in the markets. **That said, the base case remains for Fed to hike rates to 5% by May.**

While the recent macro data has been encouraging, in our view it leaves **Fed little room to sound too dovish too early**. Average hourly earnings growth has showed signs of cooling as economic momentum faded towards the year-end, but now leading indicators appear to be bottoming at only mildly contractionary levels. As we wrote in *Research Global - Global manufacturing PMI heading higher in H1*, 25 January, we now expect global manufacturing PMIs to start recovering already in Q1. The recovery could simply come too early for the Fed, as the labour market conditions remain too tight.

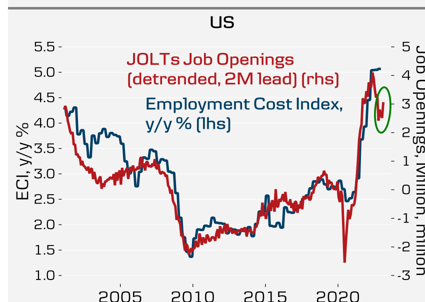
The decline in Q4 employment cost index to 1.0% q/q was a welcome, but not sufficient sign of wage-driven inflation cooling. The December JOLTs Job Openings rebounded to the highest level since July 2022, which suggests that labour demand was not markedly affected by the overall weak economic activity in late 2022. The current level of job openings indicates that ECI growth could even rebound in Q1, and the clear uptick in the January Service PMI input cost index underlines the same risk.

Powell implicitly noted that the need to maintain nominal policy rates high depends on the expected levels of inflation. **Fed does not foresee policy rate cuts for this year, but it reflects Fed's inflation forecast, which is higher than what markets are currently pricing in**. If inflation does come lower faster than Fed anticipates, Powell appeared open to lowering policy rates to avoid real rates rising to overly restrictive levels.

Especially consumers' inflation expectations will be the key to follow. For growth, it's important to note that **Fed is still looking to maintain real rates restrictive for longer**, even if continuing decline in inflation expectations would allow for nominal policy rate cuts later in the year. While we lifted our forecast for the US GDP last week and now only look for a modest recession in H1, we expect growth pace to remain subdued towards 2024.

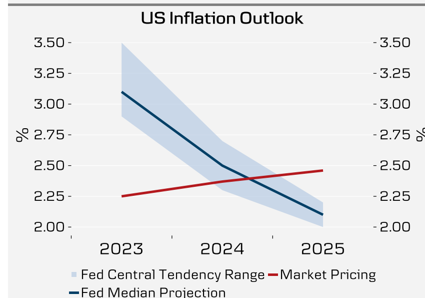
US growth potential is still constrained by persistent labour shortages, and with China now taking even larger share of the global demand, too loose monetary policy can still risk prolonging the underlying inflation pressures from here. We continue to expect two more 25bp hikes in the March and May meetings. We also see strong USD as a key part of restrictive financial conditions, and maintain our forecast for EUR/USD at 1.03 in 12M.

Labour markets remain out of balance



Source: Macrobond, U.S. Bureau of Labor Statistics (BLS)

Powell was not overly worried about market pricing in rate cuts, as it reflects market's lower expectations of inflation this year



Source: Refinitv, Fed. Central Tendency Range disregards three highest and three lowest individual contributions. Fed forecasts PCE inflation, inflation swaps are based on CPI

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