



The U.S. Federal Reserve kept rates steady at its June meeting. Our base case is that the Fed will indeed raise rates in July, with the obvious caveat that a deterioration in inflation or employment data could make the Fed more inclined to hold rates steady for another meeting. Frances Donald, Global Chief Economist and Strategist, Multi-Asset Solutions Team, discusses three main implications in this market note.

Beyond the Fed’s hawkish “pause”: three macro elements to consider

After aggressively raising rates by a cumulative 500 basis points (bps) since March of last year, the [U.S. Federal Reserve \(Fed\) left its policy rate unchanged](#) at 5.25% at its June meeting. The accompanying statement mentions that holding the target rate steady this month will allow the Federal Open Market Committee (FOMC) to gather “more information” to determine if additional monetary tightening is needed. However, FOMC members also signaled their intention to raise rates two additional times by the end of the year. All in all, the underlying message from this decision can basically be summarised as: “better, but higher and longer.”

A better economy, as the summary of economic projections mostly revealed an improved economic outlook: stronger, but still weak, economic growth in 2023 with a modest rebound in 2024, an unemployment rate that rises by less than expected, to 4.5% by the end 2024, and more persistent core inflation.

Higher rates, as the FOMC’s famous “dot plot” implies a material risk of a rate hike as soon as July, and potentially another one later this year. Our base case is that the Fed will indeed raise rates in July, with the obvious caveat that a deterioration in inflation or employment data could make the Fed more inclined to hold rates steady for another meeting

But most importantly, **higher rates for longer**. In his press conference, Fed Chair Powell mentioned that risks to inflation “are to the upside” and that interest rate cuts are probably “a couple years out”. In other words,

Powell pushes back against markets pricing in early rate cuts.

From a global perspective, none of this is new. Over the past year, we’ve noticed that central banks have demonstrated two substantial biases. First, moving earlier and faster in the presence of inflation is better than moving late and slow (i.e., front-loading rates is preferable). Second, we now see that there’s a critical distinction between pausing and pivoting. For instance, the [Reserve Bank of Australia](#) (RBA) and, more recently, the Bank of Canada (BoC) resumed hiking rates after indicating they were pausing.

The macro context surrounding the RBA and the BoC’s respective decision to raise rates is key: sustained, elevated levels of inflation, which are similar to what we’re seeing in the U.S. economy and many parts of the world.

Yet, the most important question for economic forecasters doesn’t relate to rate hikes or how much higher rates can go, but what the shape of the next interest-rate easing cycle will look like. While the mainstream narrative will likely focus on whether the Fed will hike again at its next meeting on 28 July, we think the more important question for investors is *how* and *when* the central bank will respond to the expected slowdown in U.S. growth.

Looking back, we know that the Fed responded to the last three recessions by announcing interest-rate cuts shortly after signs of economic distress became observable. It could be slightly different this time. While we still expect the Fed to begin cutting rates in 2024, we think it will be less inclined to ease relative to past cycles, particularly over the next 6 to 12 months. In our view, how the next easing cycle could look—and the extent to which rates could fall—will depend on three

characteristics of the coming recessionary environment.

1. Prices may continue to fall, but 2% inflation remains elusive

We have fairly high conviction that U.S. headline inflation will fall to around 3% by year end, but the odds of inflation hitting 2% or below in the near term are lower than they've been in the past. Indeed, we continue to believe that supply-side issues and global factors such as deglobalization, political conflicts, and increasingly frequent and severe weather events are making the hoped-for return to 2% inflation more challenging. This is relevant not just to the Fed, but central banks globally, many of whom might need to make a difficult choice:

- Accept that there's a limit to how far monetary policy—specifically, interest rates—can influence price levels and concede that a higher inflation target is necessary, or
- Actively pursue their respective inflation target at the expense of growth, recognizing that such a policy choice could potentially lead to more frequent recessions and a structurally lower growth profile.

2. Return of the two-speed economy

A two-speed economy, in which the manufacturing/goods segment of the economy is running in a deeper contractionary space than the services and labor economy, is likely to make an unwelcome return to the United States. Crucially, while we expect the U.S. unemployment rate to rise in the coming year, it's likely to rise by less than it did during past recessions. In our view, labor supply will continue to be an issue—a function of structural changes in the economy—and it's likely to affect the services sector the most. That said, while we expect the jobless rate to remain relatively low, we could see other challenges within the labor market (e.g., weak *hours* worked and below-trend wage growth). This may give the Fed and other central banks some cover to maintain a relatively *less* accommodative approach to monetary policy than they had done in past recessions. This is one reason why we believe that the Fed's next rate-cut cycle may not go as far as previous easing cycles.

3. A recession may be on the horizon, but we could still see signs of excesses in asset prices

Recession concerns may be elevated, but key U.S. stock indexes seem to be telling a different story, thanks to the exuberance brought about by progress in the artificial intelligence space. Look deeper, however, and the cracks begin to show. It's still too early to write off the [U.S. regional banking crisis](#), which continues to percolate beneath the surface—the scale of its impact on the commercial real estate sector has yet to be fully understood.

Unlike past economic cycles in which signs of banking system stress and stock market declines would convince the Fed to reverse its tightening policies and thereby trigger the [Fed put](#), this time could be different. The default setting may no longer apply and markets might need to recalibrate their expectations.

As we've argued previously, central banks' approach to policymaking has evolved and falls in asset prices could well have become a *feature* of central banking thinking rather than a *bug*. As such, we believe the Fed could be less motivated to implement ultra-easy policy in the face of market events when compared with the past. The macro backdrop is in the process of becoming more complicated and caution is certainly warranted.

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