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July 26, 2023

Fed Raises Target Rate as Expected and Holds Forward Guidance Unchanged; Rates Likely to Hold Steady at the Fed's Next Few Decisions

- **The Fed raised their target rate one quarter percentage point at the July 26 decision as expected by forecasters and financial markets, and held other aspects of their monetary stance steady.**
- **The Fed's interest rate setting committee modestly upgraded its assessment of economic growth but otherwise kept their guidance the same.**
- **The Fed is likely to skip a rate hike at its next decision in September, like in June, meaning the following decision on November 1st will probably be the next time they seriously consider raising rates again.**
- **But by then, it will probably be clear that core inflation is slowing. The Fed will probably refrain from a hike in November, or for that matter making any further rate hikes in this cycle.**
- **The next change in the Fed's policy rate is more likely a cut, which Comerica forecasts for March 2024.**

As expected, the Federal Reserve raised the federal funds target a quarter percentage point to a range of 5.25% to 5.50% at the July 26 meeting of the Federal Open Market Committee (FOMC), the group who set the Fed's policy rate. The FOMC signaled at its previous decision in June that a hike was likely in July. The Fed also continues to reduce their holdings of government-backed securities according to a plan they announced last year.

The Fed held their forward guidance largely unchanged. They upgraded their assessment of recent economic growth to "moderate" from "modest" in the June FOMC statement, but still see their immediate task as "determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time." That means that more hikes could be necessary if inflation stays stubbornly above target. On the other hand, they might be done hiking rates if inflation continues to slow.

The Fed did not update their dot plot, the diagram that summarizes policymakers' forecasts for the economy and their views on the course of monetary policy that is most likely to be appropriate over the next few years. They publish it in the third month of every quarter, so the next release will be in September. The June dot plot showed a majority of FOMC members thought it likely would be appropriate to raise the federal funds target two more times before year-end, meaning one additional quarter percentage point hike after July.

The FOMC will probably take their time to decide whether further interest rate hikes are needed. In the press conference following the July decision, Chair Powell said that a rate hike is possible at the next meeting in September—but recall that in June, Chair Powell persuaded the more hawkish members of the FOMC to refrain from a hike by saying it is appropriate to raise rates more slowly as they approach what is likely the peak for this cycle. The same logic will likely be even more persuasive in September as core inflation and wage growth slow, more slack becomes visible in labor market data, and interest rates are higher than in June.

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That tees up the following decision on November 1 for when Fed policymakers would seriously consider another hike. With the unemployment rate near a half-century low, the Fed sees the maximum employment side of their dual mandate (maximum employment and stable prices) as met, and is largely making decisions based on inflation and the outlook for it. CPI inflation slowed from 5.0% in March (year-over-year terms) to 3.0% in June, and month-over-month increases of non-energy service prices excluding shelter—sometimes called "Supercore Inflation"—slowed in the last few months as well. Shelter cost inflation is still high in the CPI index, but is likely to slow in the second half of 2023 and in 2024 since house prices are down modestly in year-over-year terms and a big wave of new rental construction is coming to market soon. Businesses are reporting cooler input price pressures in PMI surveys, and surveys of consumer confidence like The Conference Board's show inflation expectations are falling too, albeit still at higher levels than before the pandemic.

The part of the economy where inflation pressures are most pronounced is wage growth; average hourly earnings rose 4.4% on the year in June, well above the 3.0% averaged in the last few years before the pandemic, when the labor market was strong but inflation was also well behaved. But wage growth is also likely to slow in the second half of 2023, since job openings are down a fifth from their peak in early 2022, jobless claims are up over the same period, and surveys of businesses report fewer challenges filling open positions recently.

There are still upside risks to inflation. Prices of crude oil and wholesale foodstuffs have ticked higher in the last few weeks, house prices rose more than expected in the second quarter, and the job market is considerably tighter than prior to the pandemic, which could keep wage growth high despite an incremental cooldown from maximum tightness in 2022. But the components of consumer and business demand that are most sensitive to the cost of borrowing—house sales, commercial real estate, and industrial production—are running cooler in 2023 than 2022, which should open up a modest margin of slack in the economy in the next few quarters. While another rate hike before year-end can't be ruled out, the Fed is more likely to hold rates steady through early 2024, then start gradually reducing interest rates with a quarter percentage point cut in March.