15 December 2022

ECONOMIC REVIEW | December 2022 US FOMC Meeting

Fed Hikes Fed Funds Rate by 50bps at the Dec-22 FOMC Meeting as Expected

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- *FOMC updated its growth projection… The FOMC downgraded its growth forecast for 2023, anticipating the US economy to grow below trend at +0.5% (previous forecast: +1.2%) which is the same pace projected for 2022. The Fed Chair described the positive growth to be indication of a soft landing, but considered a slowdown for the US economy given the subdued below-trend growth.*
- *Fed to keep raising FFR towards 5% next year. We expect the Fed to keep its hawkish stance until inflation clearly trending lower to around 2%. The latest FOMC projection suggests core PCE price inflation will only touch +2.1% by 2025. Consequently, this will require the fed funds rate to be raised towards 5.1% next year, and could go as high as 5.4%, as shown in the Fed's updated projection.*

Fed hikes FFR by 50bp, as expected. In line with market expectations, the Fed's FOMC decided at the Dec-22 meeting to raise fed funds rate by 50bps to 4.25–4.50%, the highest in 15 years. The smaller rate hike marks the pivot in the Fed's policy tightening cycle after four back-to-back 75bps hikes since Jun-22, and similar to our expectation and what has been priced in by market consensus. The smaller hike was also backed by recent signs of easing inflation, while further rate hike was widely anticipated given elevated inflation which remained above the Fed's 2% target, on the back of strong labour market. The Fed also reiterated its commitment to reduce Fed's balance sheet as part of its policy tightening. As of last week, the Fed's balance sheet stood at USD8.58 trillion, a total reduction of USD382.75b from the peak in mid-April 2022.

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…inflation to trend lower despite weaker forecast. The US FOMC also adjusted inflation outlook slightly higher. The Fed projected core PCE inflation to reach +3.5% next year (previous forecast: +3.1%), anticipating the decline in price pressures will be somewhat slower than expected. Fed Chair, however, explained the FOMC

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expecting a sustained improvement as the revised projection still penciled in inflation would ease further in 2023 from +4.8% estimated for this year.

3 major factors affecting inflation outlook. In analysing the source of inflation, Powell mentioned there are 3 major areas which will influence the inflation outlook. Firstly, inflation in *goods prices* which has improved recently following better supply condition, in addition to slowing demand. Secondly, the inflation in *housing-related service* charges which Powell anticipates would ease around mid-2023. Lastly, the key concern which is inflation for *prices other than housing-related service* charges (accounting for 55% of the core PCE prices), which the Fed expects will only come down when wage pressures ease. Powell shared his expectation that the formula to bring down this core portion of the PCE price index will therefore require adjustment in the US job market, and will be achieved with painful change from reduction in employment. Powell added the Fed is committed and sticking to its 2% inflation target, and no long-term review is conducted to change the Fed's 2% inflation target. To him, China's recovery will not have a negative net effect to the US inflation outlook, given China's critical role in global manufacturing and international trade which contributes towards improving supply globally. So far, latest data suggests easing inflation in the US, with the core CPI inflation having each to +6%yoy in Nov-22 for the second straight month (Oct-22: +6.3%yoy; Sep-22: +6.7%yoy).

…and fed funds rate will increase to 5.1% in 2023. Given the higher inflation outlook, the median FOMC projection predicts the fed funds rate will be raised to 5.1% (previous forecast: 4.6%) by end of next year. Although the Fed is more confident the core PCE inflation will go down towards 3.5% next year, the terminal level of its policy rate remains unclear as the risk to the US inflation outlook still remains on the upside. In other words, if inflation is stickier and easing slower than forecasted, fed funds rate could be hiked higher to ensure the Fed's policy setting will reach "sufficiently restrictive" level that will curb inflation. While the Fed's focus is to find the right level of restrictiveness in increasing the interest rates which also takes into account the moderating inflation trend, Chair Powell stressed that the Fed will likely to pause and keep fed funds rate at high level for a long period until inflation clearly returns toward 2% target.

Possible recession? Although FOMC predicts a soft landing, Jerome Powell mentioned that the higher the terminal rate for the fed funds rate will increase the recession risk for the US economy. He touched about the concern the economy would slow deeper than expected in reaction to the rise in borrowing costs, changes in financial condition and the high inflation, which remains above the Fed's target and resulted in weaker purchasing power. Nevertheless, the actual effect will depend on the latest economic developments and changes in inflation situation, and whether inflation take longer to trend lower. At the moment, while the job market and the economy have been strong and robust after the Covid-19 pandemic, the Fed is heavily focused on bringing inflation closer to its price stability target. The painful adjustment is needed because ensure price stability will ensure a sustained expansion in the labour market and the economy in the longer-run.

Yet to see softening of the labour market. The resilience in the US economy has been backed by the robust and tight labour market. According to Jerome Powell, the structural shortage of around 3.5 million workers

basically reflects the effect of early retirement and lower migration caused by Covid-19 pandemic. So far, the US economy still added more jobs; nonfarm payrolls continued to expand by +263K in Nov-22 (Oct-22: +315K), the slowest gain since Jan-21. The US unemployment rate remained at around pandemic-low of 3.7%, with firms reluctant to let people go because of difficulty to fill in vacancies. Before we see American firms reducing employment, initial changes would come from decreases in labour demand. Overall, robust job market is the main reason that will support for a soft landing (and not a recession or negative growth) next year.

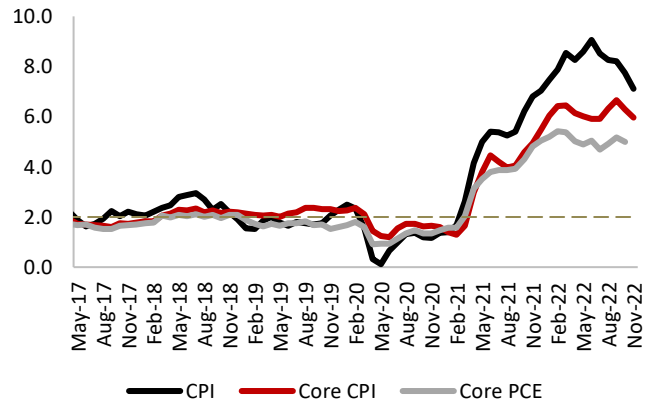
Fed to keep raising FFR towards 5% next year. We expect the Fed to keep its hawkish stance until inflation clearly trending lower to around 2%. The latest FOMC projection suggests core PCE price inflation will only touch +2.1% by 2025. Consequently, this will require the fed funds rate to be raised towards 5.1% next year, and could go as high as 5.4%, as shown in the Fed's updated projection. Given the easing inflation, we expect this will also support for the smaller rate hikes and eventually for the Fed to pause. The Fed will continue to review its decision subject to economic developments and shift in the inflation outlook, which would be influenced by supply condition, movement in commodity prices and the changes in final demand, among others. We also foresee the US to experience a soft landing given the robust labour market, but remained cautious if the softening of US aggregate demand were to be sharper or earlier than anticipated. On the local front, we expect Bank Negara will continue with its policy normalization and to raise OPR higher towards 3% by early next year. Decision to increase OPR will not only be simply influenced by the Fed's decision or US economic outlook, but will be dependent on Malaysia's economic fundamentals including the strength of domestic demand.

Table 1: Central Bank Policy Rate by Selected Economies (%)

	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22
Malaysia	1.75	2.00	2.00	2.25	2.25	2.50	2.50	2.75	2.75
Indonesia	3.50	3.50	3.50	3.50	3.75	4.25	4.75	4.75	4.75
Philippines	2.00	2.25	2.50	3.25	3.75	4.25	4.25	5.00	5.00
Thailand	0.50	0.50	0.50	0.50	0.75	1.00	1.00	1.25	1.25
Vietnam	4.00	4.00	4.00	4.00	4.00	5.00	6.00	6.00	6.00
South Korea	1.50	1.75	1.75	2.25	2.50	2.50	3.00	3.25	3.25
India	4.00	4.40	4.90	4.90	5.40	5.90	5.90	5.90	6.25
Japan	(0.10)	(0.10)	(0.10)	(0.10)	(0.10)	(0.10)	(0.10)	(0.10)	(0.10)
UK	0.75	1.00	1.25	1.25	1.75	2.25	2.25	3.00	3.00
Euro area	0.00	0.00	0.00	0.50	0.50	1.25	1.25	2.00	2.00
US	0.25-0.50	0.75-1.00	1.50-1.75	2.25-2.50	2.25-2.50	3.00-3.25	3.00-3.25	3.75-4.00	4.25-4.50

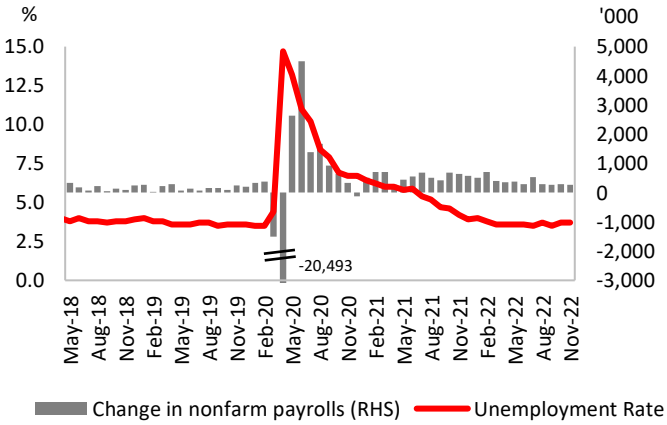
Source: Bloomberg; MIDFR

Chart 1: US CPI vs Core PCE Inflation (%)



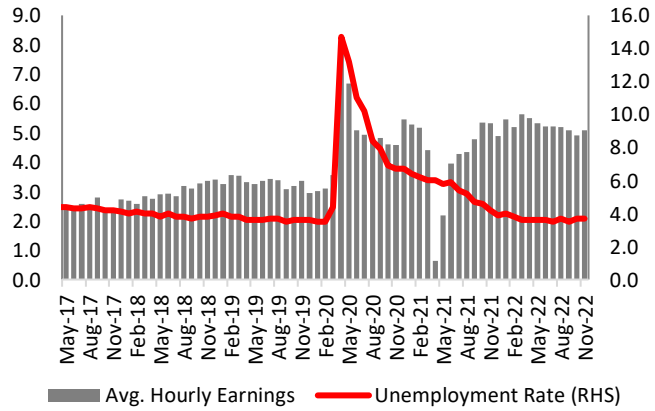
Source: Macrobond, MIDFR

Chart 2: US Unemployment Rate (%) vs Non-Farm Payroll ('000)



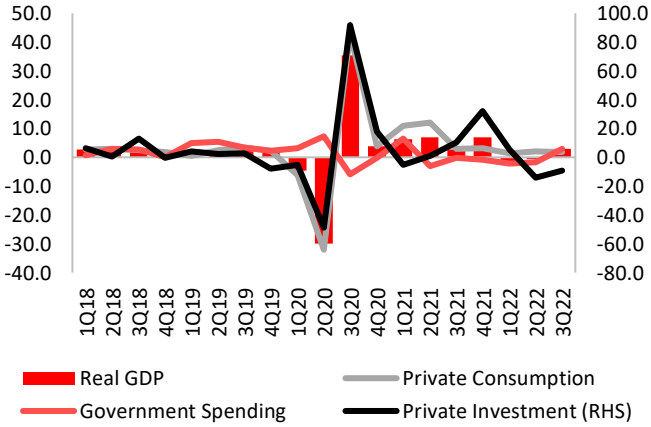
Source: Macrobond, MIDFR

Chart 3: Wage growth (YoY%) vs Unempl. Rate (%)



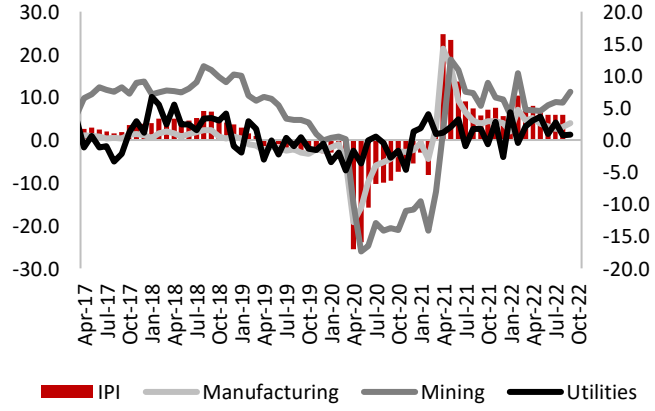
Source: Macrobond, MIDFR

Chart 4: US GDP Growth (Annualised QoQ%)



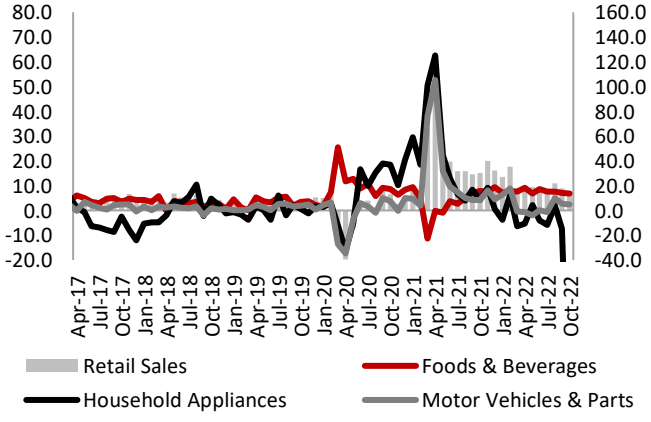
Source: Macrobond, MIDFR

Chart 5: US IPI Performances (YoY%)



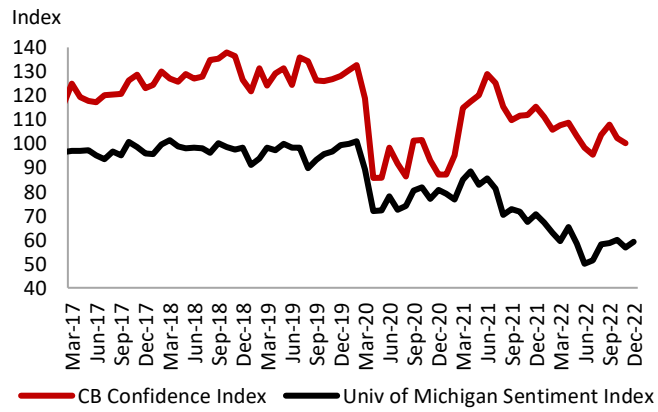
Source: Macrobond, MIDFR

Chart 6: US Retail Sales (YoY%)



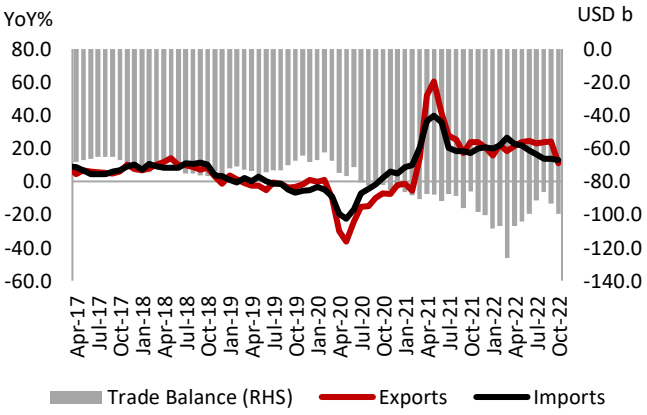
Source: Macrobond, MIDFR

Chart 7: US Consumer Sentiment & Confidence



Source: Macrobond, MIDFR

Chart 8: US Export & Import (YoY%) vs Goods Trade Balance (USD billion)



Source: Macrobond, MIDFR

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