US interest rates - another skip

Synopsis: For the second time since January 2022, the US Federal Reserve has paused its increases in the Fed Funds rate.

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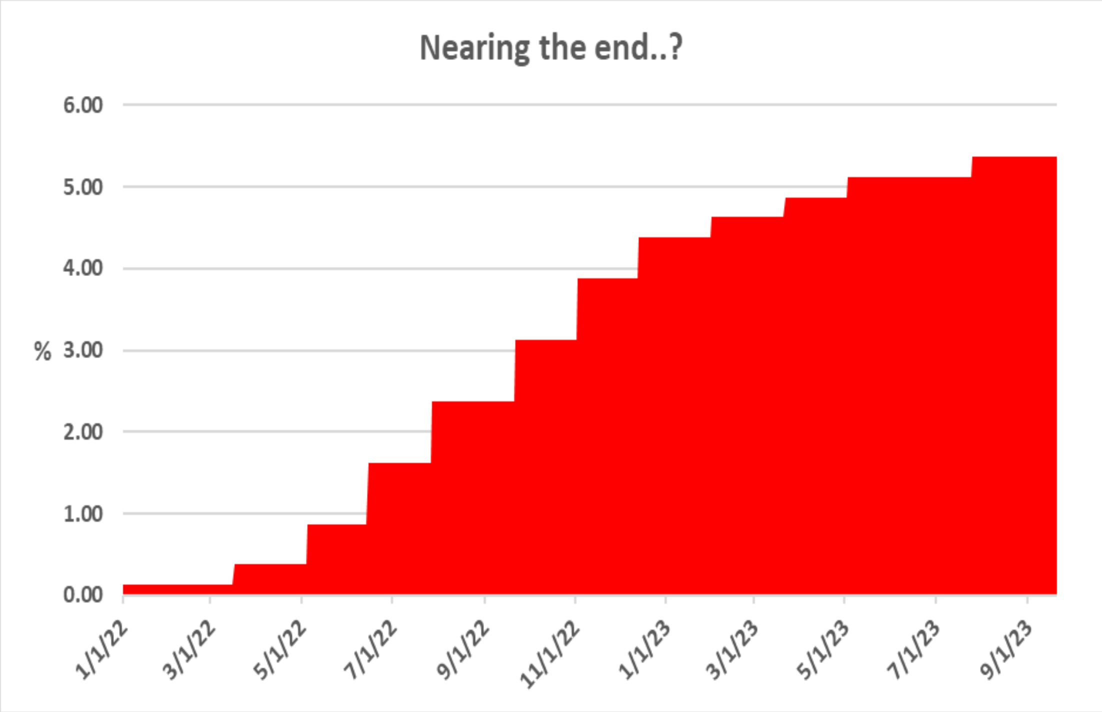


Last night, the US Federal Reserve decided to leave its Fed Funds Rate on hold at 5.25%-5.50%. The non-move had been widely expected, although what accompanied the apparent inertia was more of a surprise.

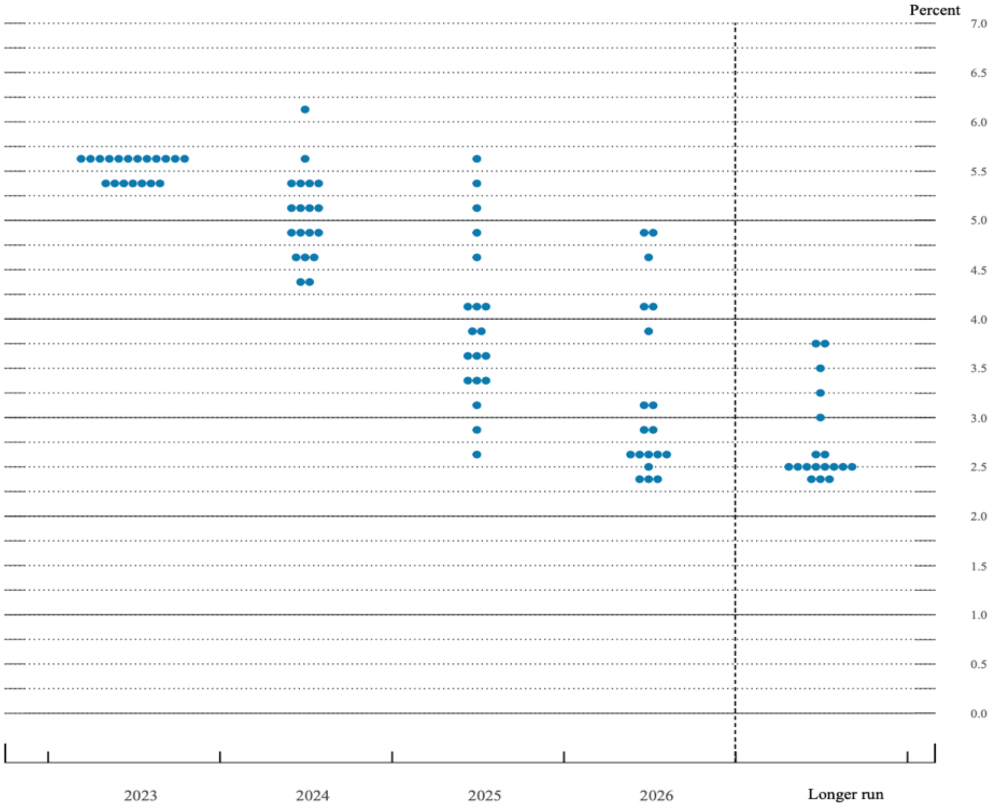
The tone of the Fed's accompanying press release reflected what has been described by Bloomberg as a 'hawkish pause'.

For example, statements such as 'Inflation remains elevated'; 'The [Federal Reserve rate-setting] Committee remains highly attentive to inflation risks' and 'The Committee is strongly committed to returning inflation to its 2 percent objective.' did not indicate any imminent desire to start marching rates down the hill.

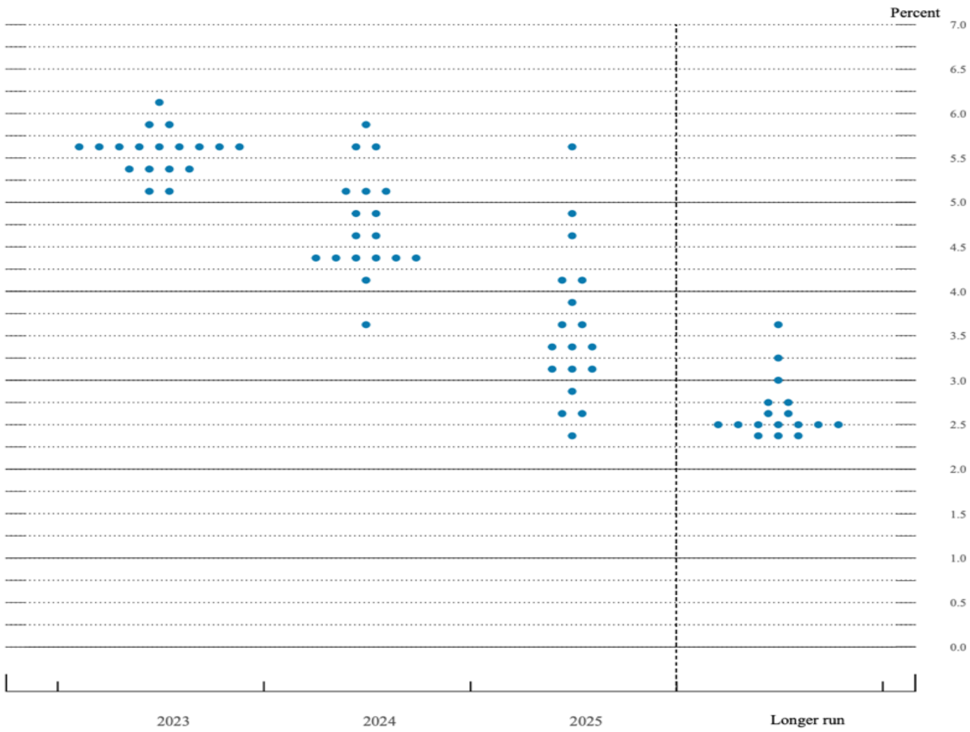
The higher-for longer tone was reinforced by the accompanying dot-plot, giving Fed's members individual estimates of interest rates (and other economic data) over the next few years.

The following page shows September's and June's interest rate plots (note the latest plot includes 2026, which the June version did not)…

September 2023



June 2023



The median figure for the end of 2023 remains at 5.6%, suggesting that there will be one more increase across the final two meetings this year. The plot also pushed up its end 2024 median rate by 0.5% to 5.1% and added the same amount to its previous end 2025 figure, taking it up to 3.9%. The markets reacted accordingly, but even after a 0.19% rise the implied rate from the money markets is still 4.76% for end 2024, pointing to a projection of 3-4 more 25bp cuts than the dot plot authors are contemplating.

US Treasury bond markets responded to the Fed's hawkishness by taking the yield on two-year bonds – most sensitive to short term rates – to a 16 year high of 5.18%. 10-year bonds had a similar historic peak (4.4%), while US 10-years Tips (Treasury Inflation Protected Securities) hit a 2% real yield for the first time since 2009. Wednesday's move in US Treasury bond yields contrasted with falls in UK gilt yields as investors on this side of the pond reacted to better-than-expected inflation numbers.

Comment

It will be interesting to see the extent to which the Fed's actions will be mirrored by the Bank of England when it meets for its interest rate decision today (Thursday). The UK's August inflation outturn of 6.7% is 3% higher than the USA's and there is an even larger gap in relative wage growth. The prospect of an extended period of 5%+ US rates has done nothing for sterling which has fallen to the lowest level since late May against the greenback.

Weak sterling does nothing to help inflation towards the Bank's elusive 2% target.