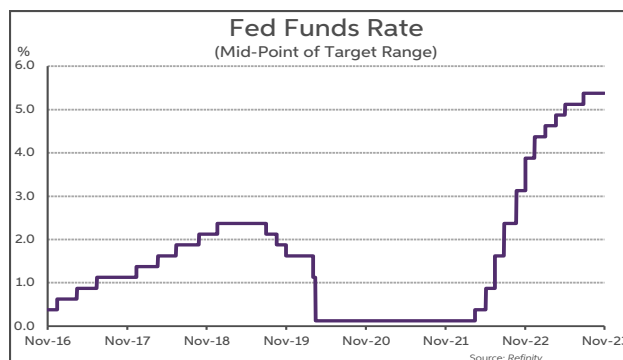


Fed holds rates steady at 22-year high for second meeting

For the second consecutive meeting and the third meeting in the last four, the US Federal Reserve Open Market Committee left its key interest rates on hold at the conclusion of its two-day meeting last night. As a result, the target range for the funds rate remains at 5.25-5.50%, a 22-year high. The Fed has enacted 525bps worth of rate increases since it commenced tightening policy in March 2022. The last rate rise came in July, with a 25bps hike.

The decision to leave rates unchanged yesterday was unanimous and also in line with market expectations. Indeed, futures contracts have been attributing only a 40% chance that there would be one further rate hike over this winter, with markets then expecting the Fed would move on to a rate cutting path later next year. Hence, most market attention yesterday was on the insights on the future path for rates provided by the FOMC statement and by the Fed Chair at his post-meeting press conference.



In this regard, Fed Chair Powell continued to keep the option open of hiking again, highlighting that the Fed is very much in data dependent mode as regards future policy decisions. This is consistent with the Fed's latest dot-plot of rate projections published at the September meeting, which showed the median projection of FOMC members remained for rates to rise to a 5.50-5.75% range by the end of 2023. The Fed Chair did observe, though, the dot plot is a picture in time whose efficacy decays during the inter-meeting period.

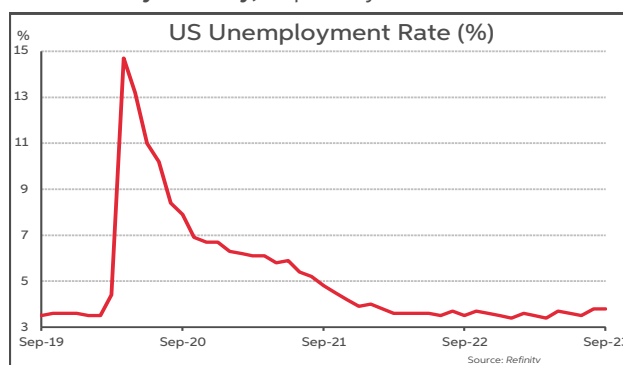
Market rate expectations softened in the aftermath of the meeting, though, while bond yields fell. The meeting statement contained one noteworthy change. In addition to tighter credit conditions, the FOMC acknowledged that tighter financial conditions are also likely to weigh on economic activity, hiring and inflation. In his press conference, Chair Powell commented that higher long term yields, a stronger dollar and weaker stocks could matter for future monetary policy decisions. However, he cautioned that tighter financial conditions would need to be persistent and the Fed is not confident yet that it has achieved a sufficiently tight policy stance for returning inflation to its 2% target.

The latest set of Fed quarterly macro forecasts were published in September. In terms of economic activity, the Fed upgraded its Q4 2023 GDP growth forecast sharply to 2.1% y/y from 1.0%. This now looks likely to be exceeded after much stronger than expected Q3 GDP data. Labour market data have also proved stronger than anticipated in the third quarter. The September projections showed the Fed expects GDP growth to slow to 1.5% year-on-year by Q4 2024, before picking up slightly to 1.8% y/y by Q4 2025.

Meanwhile, the Fed's projection for the core-PCE inflation rate in Q4 2023 was revised down from 3.9% to 3.7% in the September forecast. However, the latest data show the core PCE rate fell to 3.7% in September from 3.8% in August and 4.3% in July. This suggests downside risk to the Fed's Q4 2023 inflation forecast. Meantime, the projections show the core-PCE rate falling to 2.6% in Q4 2024 and 2.3% in Q4 2025. It is seen hitting the 2% target in 2026.

In the aftermath of the meeting, futures contracts eased slightly to show just a 25% probability of one final rate hike this winter. However, the Fed kept the door open for a further rate hike yesterday, especially as financial conditions could soften again. Indeed, in the past week, ten year yields have fallen by 30bps, stocks have risen and the dollar has lost some ground. Furthermore, the economy would likely also need to slow and labour market soften to avoid a rate hike.

Further down the road, markets see rates almost 85bps below their current level by end 2024, at just above 4.5%, with rates seen declining by a further 50bps to near 4% by end 2025. Interestingly, the median dot-plot in September showed the FOMC expects rates to be lowered to just 5.125% by Q4 2024, and then to 3.875% at Q4 2025. This points to the Fed being much slower to cut rates next year vis-à-vis market expectations, with rates staying above 5%, before aggressively lowering them during 2025.



US economy performs very strongly in 2023

The US economy continues to perform very strongly.

GDP expanded by between 2.1-2.7% annualised per quarter between mid-2022 and mid-2023, before growing by a very robust 4.9% annualised rate in the third quarter of this year. Meantime, real final domestic sales rose by 3.5% in Q3, up from 2.1% in Q2. Overall, the data show that the US economy, which was already growing at a strong pace, gained further momentum in Q3, with year-on-year GDP growth picking up to 3%.

Regarding the underlying breakdown of GDP in the third quarter, consumption rose sharply by 4% annualised, contributing a significant 2.7 percentage points (p.p.) to the total. Fixed investment added a further 0.2 p.p. to growth. Government spending jumped by 4.6% in Q3, led by an increase in defence expenditure (although, non-defence spending also rose), boosting GDP by 0.8 p.p.. Net trade subtracted 0.1 p.p. from growth, while inventories contributed a large 1.3 p.p. to the GDP total.

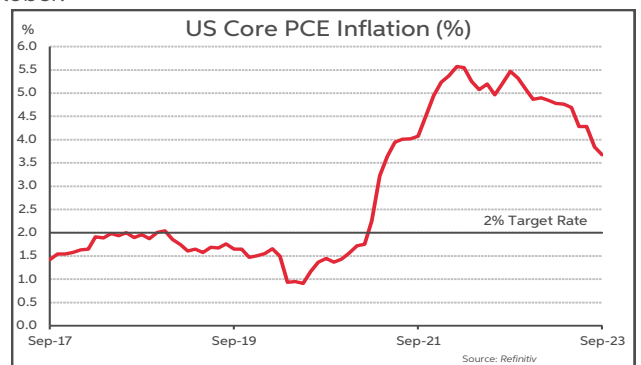
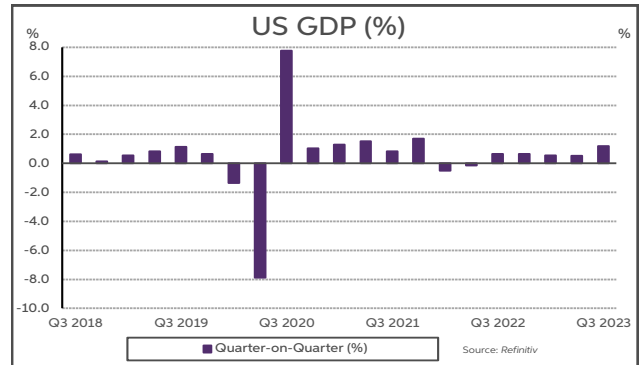
In terms of the labour market, conditions remain very tight. Payrolls expanded at a robust pace in Q3, rising by an average of 266k per month, compared to an average of 257k per month in the first half of the year. Indeed, payrolls rose by 336k in September, the fastest monthly increase since January of this year. Meantime, the number of job openings stood at 9.55m in September, up from 9.5m in August and 8.9m in July, though well below the total of 11.2m at the end of 2022. Elsewhere, the unemployment rate edged higher to 3.8% in August, its highest level since February 2022, and stayed at that level in September. Meanwhile, weekly jobless claims remain very low. Against this backdrop of still tight labour market conditions, average earnings growth remains elevated, at 4.2% year-on-year in September, although, this is down from 4.8% last December, and a peak of 5.9% in March 2022. However, the closely followed wages component of the employment cost index rose by 1.2% q/q in Q3, up from 1% in Q2.

Likewise, headline inflation has proven to be more sticky recently, having fallen sharply in the first half of the year. Headline CPI inflation jumped to 3.7% in August and remained at that level in September, up from 3.2% in July. However, this is still well below the peak of 9.1% registered in June 2022, and can largely be attributed to a sharp rise in fuel prices, which jumped by 10.6% in August, and 2.1% in September. Meantime, core inflation has continued to trend lower, with core-CPI falling to 4.3% in August, and to 4.1% in September. The September reading was the lowest since October 2021. Similarly, core-PCE had been in a narrow 4.3-4.9% between December 2022 to July 2023, before declining to 3.8% and 3.7% in August and September. The Fed expects core-PCE inflation to move slowly towards the 2% target over the next three years, reaching 2% in Q4 2026.

The limited amount of survey data available for October have been somewhat mixed. The flash reading of the services PMI inched higher to 50.9 from 50.1, indicating a slight improvement in business conditions. Elsewhere, the manufacturing index printed at 50.0, consistent with a stabilisation of conditions in the sector, following five consecutive months in contraction territory. However, the manufacturing ISM fell 46.7 to in October, which was the twelfth consecutive month it has remained below 50. Both the Conference Board and University of Michigan measures of consumer confidence also deteriorated in October.

To surmise, the US economy has performed very strongly in the first three quarters of this year. Furthermore, the US appears to be relatively unscathed by the stresses which emerged in parts of its banking system this spring. However, the impact of high inflation and significant monetary policy tightening over the past year are still working their way through the economy. GDP growth is set to average around 2.5% this year. The Fed sees growth easing to 1.5% y/y in Q4 2024, and then picking up to 1.8% y/y in Q4 2025. The IMF sees GDP slowing to 1.5% in 2024. **However, the lagged effects of**

monetary tightening and slower global growth mean the risks to the US economic outlook are tilted to the downside. Additional tightening may also be needed if labour market conditions remain tight, and inflation proves to be sticky. Overall, while the economy looks on course for a soft landing, even the Fed is warning that it is too early to proclaim victory in the fight against inflation, without there being a downturn in activity.



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