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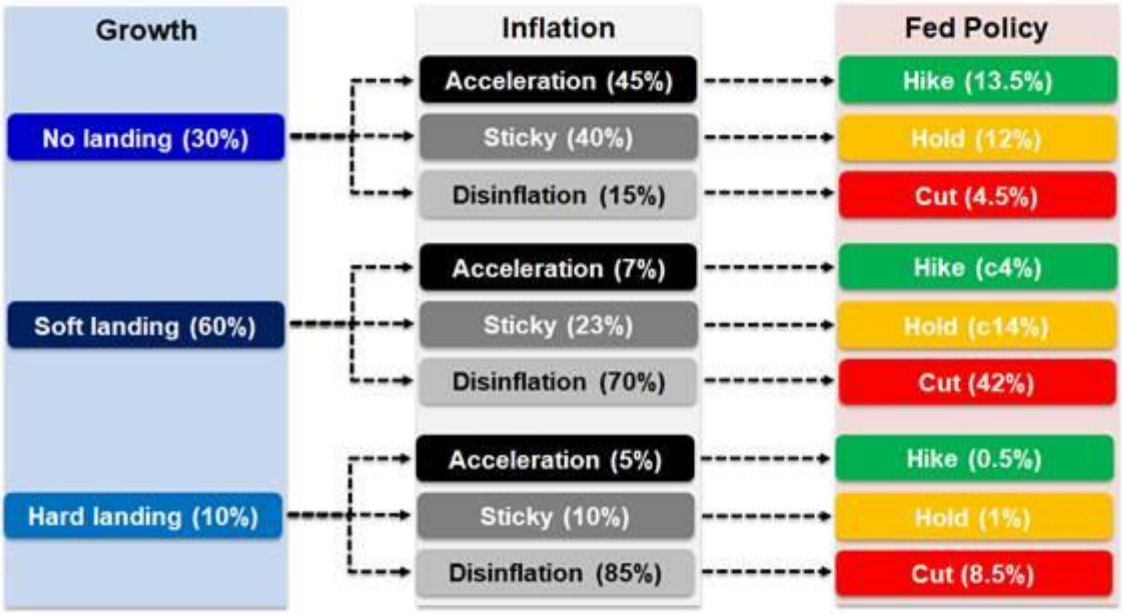
Bottom line: going into the Apr-May FOMC meeting, markets had just one question – 'will the Fed pivot again to a hawkish stance and raise rates to fight sticky inflation?' Chair Powell answered by talking up their preference for 'holding for longer' over 'hiking further.'

- **As expected, the Fed kept its policy rates unchanged at 5.25%-5.50%.**
- **A QT taper focusing on treasury securities starting June was also announced.**
- **While focused on inflation risks, FOMC believes that the policy is sufficiently restrictive.**
- **In absence of a major leg higher in inflation, we see two rate cuts in 2024.**

- **The assessment**
  - The Federal Reserve's press release mentions that "*Recent indicators suggest that economic activity has continued to expand at a solid pace. Job gains have remained strong, and the unemployment rate has remained low. Inflation has eased over the past year but remains elevated. In recent months, there has been a lack of further progress toward the Committee's 2 percent inflation objective*".
- **The decision**
  - **Policy rate:** FOMC left the policy rate unchanged at its 23-year high of 5.25%-5.50%.
  - **Quantitative tightening:** FOMC announced a reduction in the pace of its balance sheet run-off by reducing the *monthly redemption cap on Treasury securities from USD60bn to USD25bn [beginning on June 1]. The Committee kept the monthly redemption cap on agency debt and agency mortgage-backed securities unchanged at USD35bn.*
  - **No contradiction:** During the press conference Chair Powell was asked if he sees the QT taper resulting in easier conditions and going against their inflation fight, and he was firm in stating that he does not. We concur with this assessment especially given that the Fed has come a long way in reducing its balance sheet size.
- **The (greater) confidence**
  - The Fed continues to look for evidence of inflation moving sustainably towards its 2% target. When assessing the situation, the Fed has repeatedly mentioned that it looks at the totality of data.
  - This means two things:
    - The Fed does not need inflation at 2% to start cutting interest rates, rather it needs convincing evidence that disinflation has resumed.
    - Further, till the data provides greater confidence, the Fed is likely to keep rates elevated. However, the chances of increasing rates further are low.
- **The reaction function**
  - As per The Federal Reserve's press release, "*The Committee judges that the risks to achieving its employment and inflation goals have moved toward better balance over the past year. The economic outlook is uncertain, and the Committee remains highly attentive to inflation risks."*
  - While the risk balance has moved towards a better balance, we think it is still not evenly balanced. To that extent, the Fed is still more focused on inflation risks than risks to employment given the easing tightness in labour market conditions. But this could change as the year progresses.

- **Our outlook for the Fed policy rate**
  - We think the Fed will cut interest rates twice this year. Of course, the path to a rate cut has narrowed over the past few months and the probability of a rate hike has also increased. Further, given Fed's data dependency, timing of the rate cuts is also difficult.
  - The Fed's reaction function to data will evolve over the course of the next several months. While the Fed may appear to be paying more attention to inflation now, we think it will turn more sensitive to softer growth in H2'24.
  - Our central case assumes below-trend growth (this is our soft-landing scenario) and resumption of disinflation in H2'24. Against this backdrop we think the risk balance will become even more balanced and may even tilt towards growth (employment) over the coming months.
  - In the exhibit below, we lay out our subjective probabilities for various scenarios of growth and inflation and the potential action from the Fed. Taking into account our base-case and risk scenarios for both growth and inflation, along with our assumptions for the Fed's reaction function (discussed above), we assign a subjective probability of 55% to a rate cut this year while the probability of staying on hold is at 27% and the odds of a hike are at 18%.

US monetary policy outlook: our scenario-based approach



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