

FOMC:

## The eagle has ... paused

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### Executive Summary

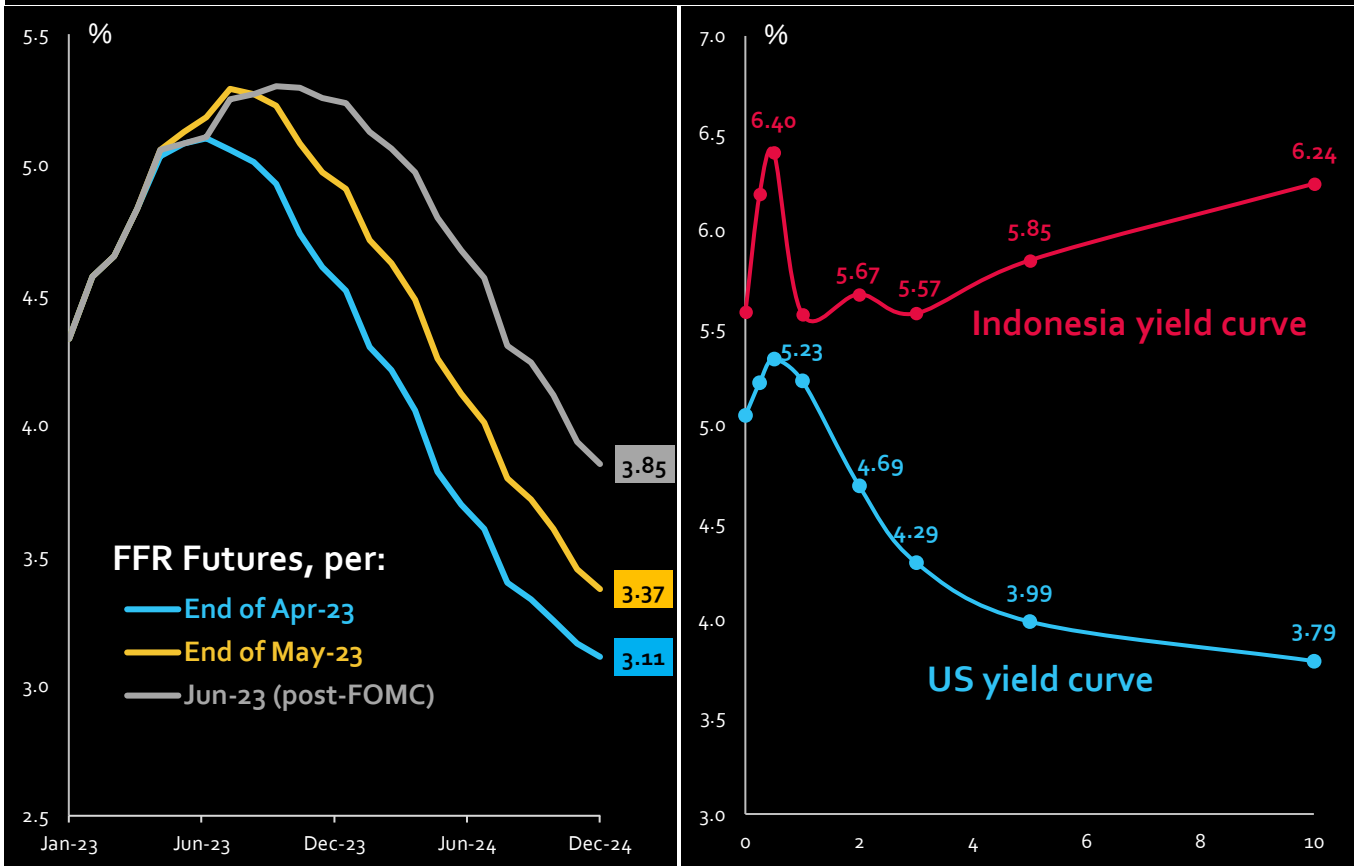
- The Fed paused rate hikes in June, but coupled with more hawkish forward guidance seemingly aimed at quelling market excitement about a potential pivot.
  - Headline macro numbers in the US remains robust, but cracks are beginning to appear in the job market which may suggest that the current Fed policy is already too tight.
  - Large US Treasury issuance in H2-23 could act as force multiplier for Fed QT by draining market liquidity at much faster rates.
  - Fed appears to have little room to tighten further, but its implied tolerance for recession in order to curb inflation could be a drag for risk assets, including EMs.
  - Indonesia has been the crème of the crop among EMs which gives BI a chance to cut earlier than the Fed, but global uncertainties may push this towards early 2024.
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- The Federal Reserve finally takes a breather in its hiking cycle, 15 months since its first hike and 500 bps away from the ZIRP regime during the lockdowns. The decision had already been telegraphed to the financial market, which pretty much accepted that the June 14th meeting would be a “skip” while the Fed remains open to hiking in July. There was also little doubt that this would be a “hawkish pause”, with the Fed reaffirming its priority to quell inflation.
  - But the Fed went further, with the dot plot now suggesting two more hikes before year-end – justified by growth and unemployment projections that are much rosier compared to March. Chair Jerome Powell even suggested that rate cuts might still be two years away depending on inflation, although this is contradicted by the Fed’s own dot plot which indicates 100 bps cut in 2024.
  - There is logic to this harsh Fed speak, and that is to quash speculation that this pause marks the start of a “pivot” back to looser policy. Powell might have also felt the need to tone down the market’s exuberance, particularly after the conclusion of the debt ceiling saga. Indeed, the S&P 500 index has performed well YTD despite flat central bank liquidity – partly the result of AI-hype – while conditions in the housing market has actually improved even if house prices continue to fall.
  - What we are seeing, then, is a shift in the Fed’s tactics from relying primarily on actual rate hikes to one more reliant on messaging (“jawboning”). Further rate hikes are not out of question, of course, but this would depend on data, while the Fed’s own statements and projections cannot be taken at face value.

- So are the data supportive of more rate hikes? It depends on how one looks at them. US GDP growth is indeed still robust, potentially rebounding to 2% YoY (or slightly below that) in Q2. CPI inflation fell sharply in May, but core services has not declined appreciably – partly linked to the still-strong wage growth at around 6% YoY. Finally, payroll growth has softened in the last four months, but is still much faster than the vaunted boom years under the Trump admin (2017-19).
- But some doubts are starting to creep in. Jobless claims are starting to rise, while the strong wage growth figure is likely a product of base effect – weekly earnings growth in Q1-23 was only 4.1% (annualized). The payroll growth slowdown has also put the Sahm recession indicator in the (slight) positive, albeit nothing that would suggest imminent recession, while the two more traditional recession canaries – US Treasury yield curve and Leading Economic Index (LEI) – has done little to suggest that recession could be avoided a few quarters down the road.
- The Fed is also shifting from being seemingly too nonchalant about inflation to being too uptight about it. Actual PCE inflation have crossed the Fed's 6-months forward expectations back in March, and the gap between the two would grow much wider if PCE follows anything like CPI's trajectory in May.
- Recall also that the Phillips curve is closer to a parabola rather than a straight line, and the inflation-unemployment tradeoff generally does not happen gradually nor simultaneously. Rather, inflation could fall rapidly at first without much change in employment. Afterwards, unemployment would gain momentum and rises rapidly with only limited decline in inflation. We are probably at the first phase right now, but the second phase – once it starts – may be hard to stop.
- The Fed's hawkish pause, then, buys it some critical time to reconsider its policies. We do believe that the Fed is reluctant to appear dovish, which does make the chance of any rate cut in 6 months' time very limited. However, there is a decent chance that the Fed is hanging up its hiking boots (at least after one last hike in July), replaced by mere jawboning ...
- ... and by the still-ongoing quantitative tightening (QT), whose bite may begin to be felt in the months ahead. To date, the decline in the Fed's balance sheet has been offset by the US government's withdrawal from its Treasury general account (TGA). The latter effectively transferred liquidity from the public sector to the private sector, such that the amount of reserves for the financial system as a whole (bank reserves plus reverse repo/RRP) have been flat – not declining – since early 2022.
- Post-debt ceiling deal, however, things could change as the US government sets to refill its coffers by issuing almost USD 2 Bn in T-bills. In the ideal scenario, this would be achieved at the expense of the less liquid RRP, but – depending on yields and the flow of funds within the financial system – it may primarily drain bank reserves instead. This raises the specter of liquidity issues which could affect markets worldwide, even though it could also force the Fed to intervene and end QT early (just like after the repo rates spiked in 2019).
- From the perspective of an emerging market like Indonesia, a Fed that has little room left to tighten – both on the rate and QT fronts – would seem like a godsend, especially amid falling commodity prices. Recall that periods of strong USD/weak commodities like 2014-15 could

be very disruptive for growth, especially with monetary policy having to be kept restrictive to stabilize exchange rates.

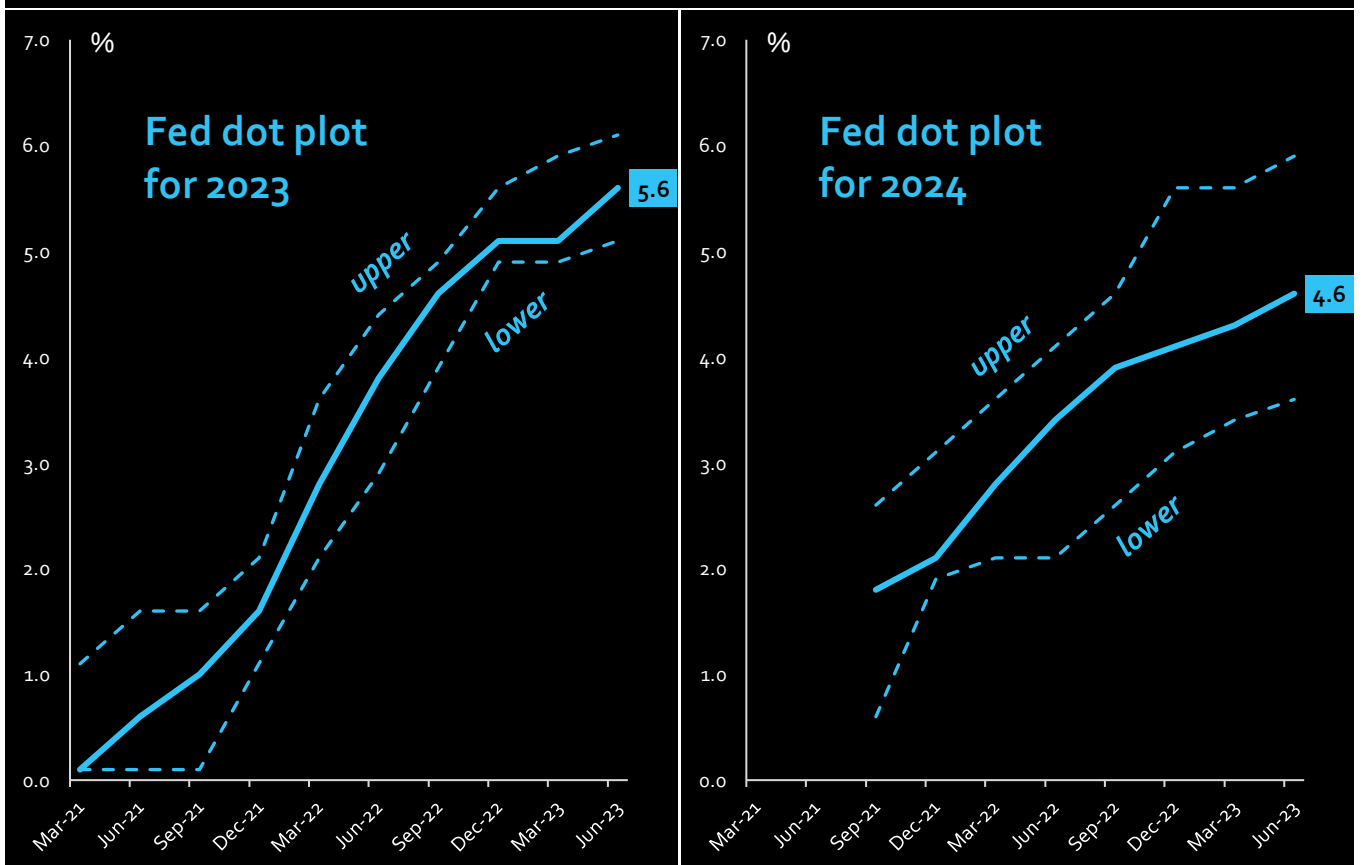
- There is, however, no guarantee that the USD would continue weakening, especially since the Fed's messaging suggests that it could tolerate recession to attain its inflation goal. This is one reason why we think BI will remain cautious and await further developments before cutting rates – likely in H1-24 – even though many factors may show that it can afford to do so early. These include, most notably: narrowing NDF-spot spread for USD/IDR, declining CDS basis, and a faster decline in inflation owing partly to cheap Chinese imports.

**Panel 1. Fed pivot hopes continue to recede ever further into the future, but without bear steepening in UST, Indonesian gov't bonds retain healthy yield differentials**



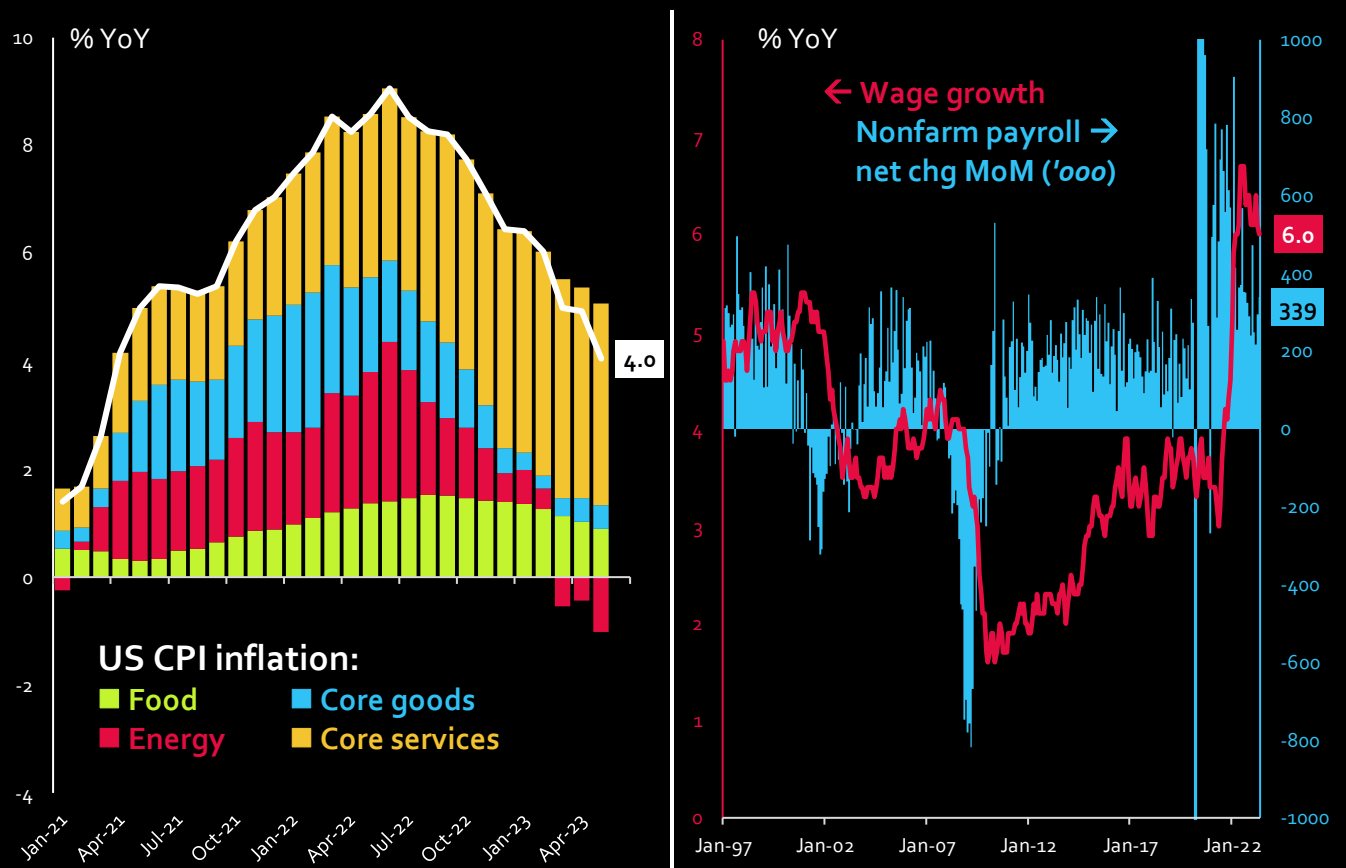
Source: Bloomberg, BI

**Panel 2. Fed pencils in two more hikes for 2023, but baseline expectations of a pivot next year remains intact**



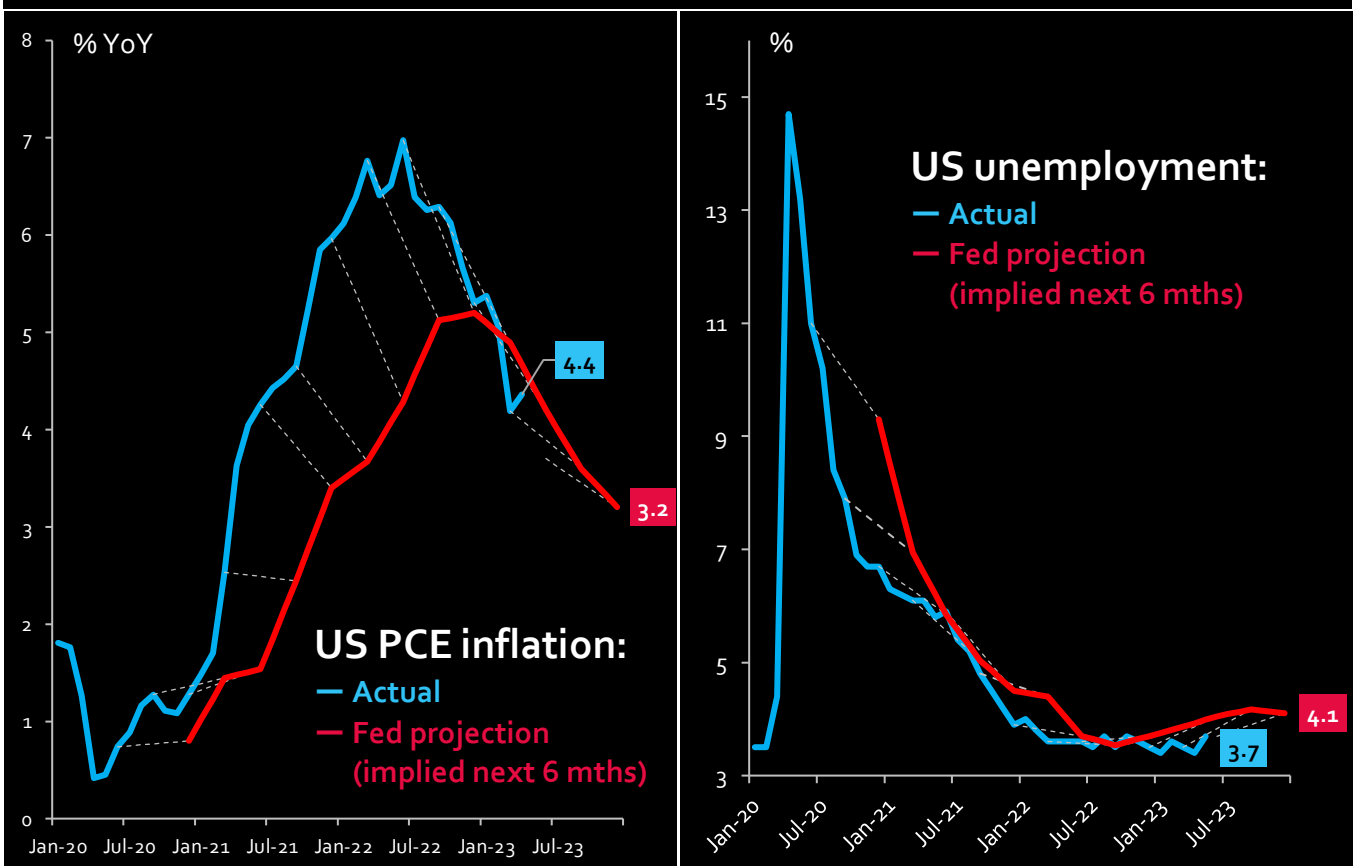
Source: Federal Reserve

**Panel 3. Supply-side inflation is declining rapidly, but wage-linked services inflation remains stubborn enough to warrant further Fed hawkishness**



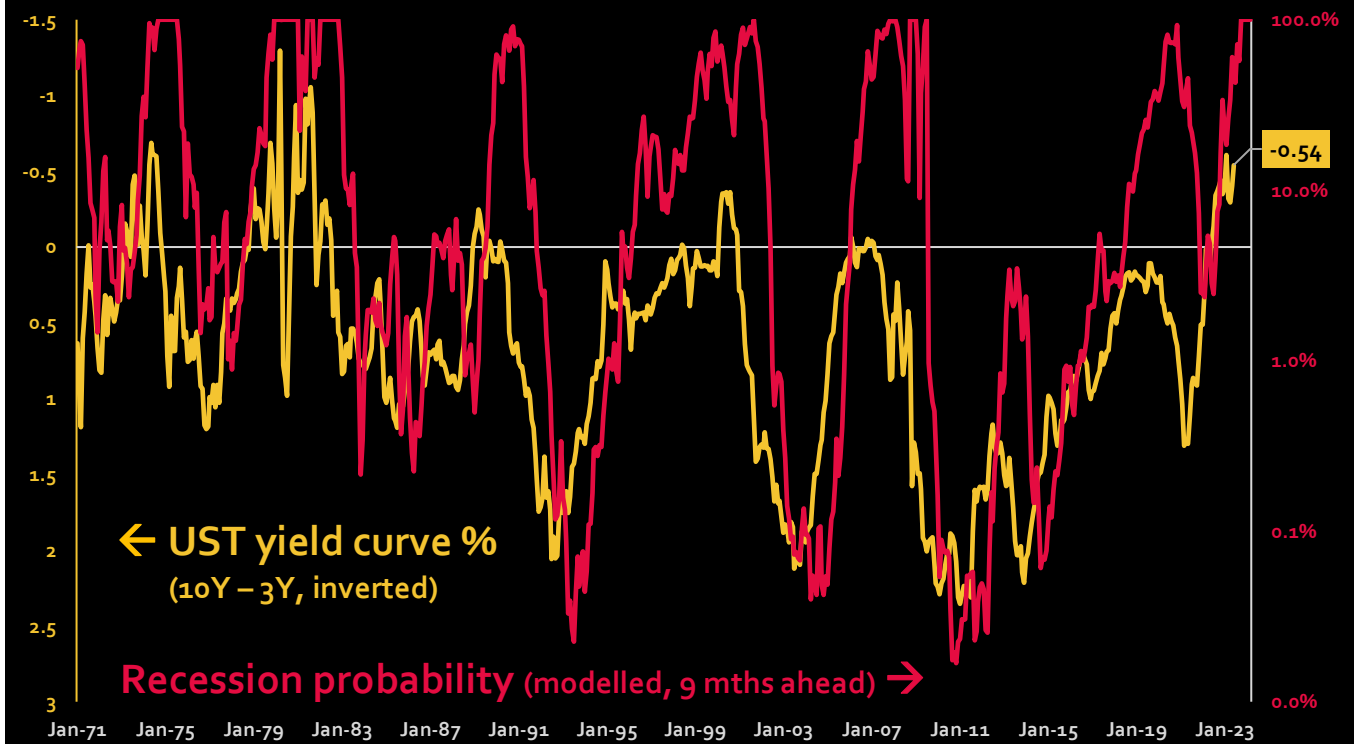
Source: US BLS, Bloomberg

**Panel 4. After earlier complacency, the Fed foresees stickier inflation going forward, coupled with modest rise in unemployment**



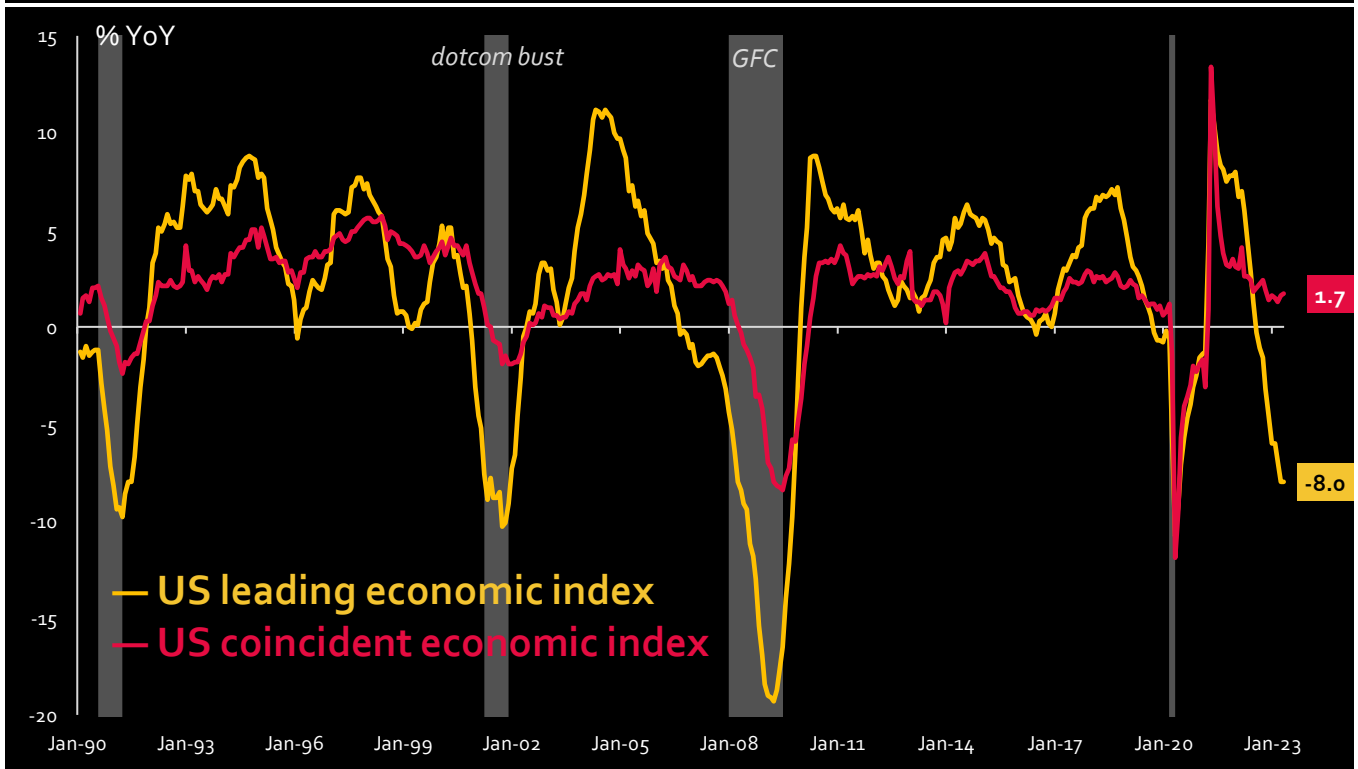
Source: Bloomberg, Federal Reserve

**Chart 1. The traditional yield curve indicator projects US recession with near-certainty by Q4-23 ...**



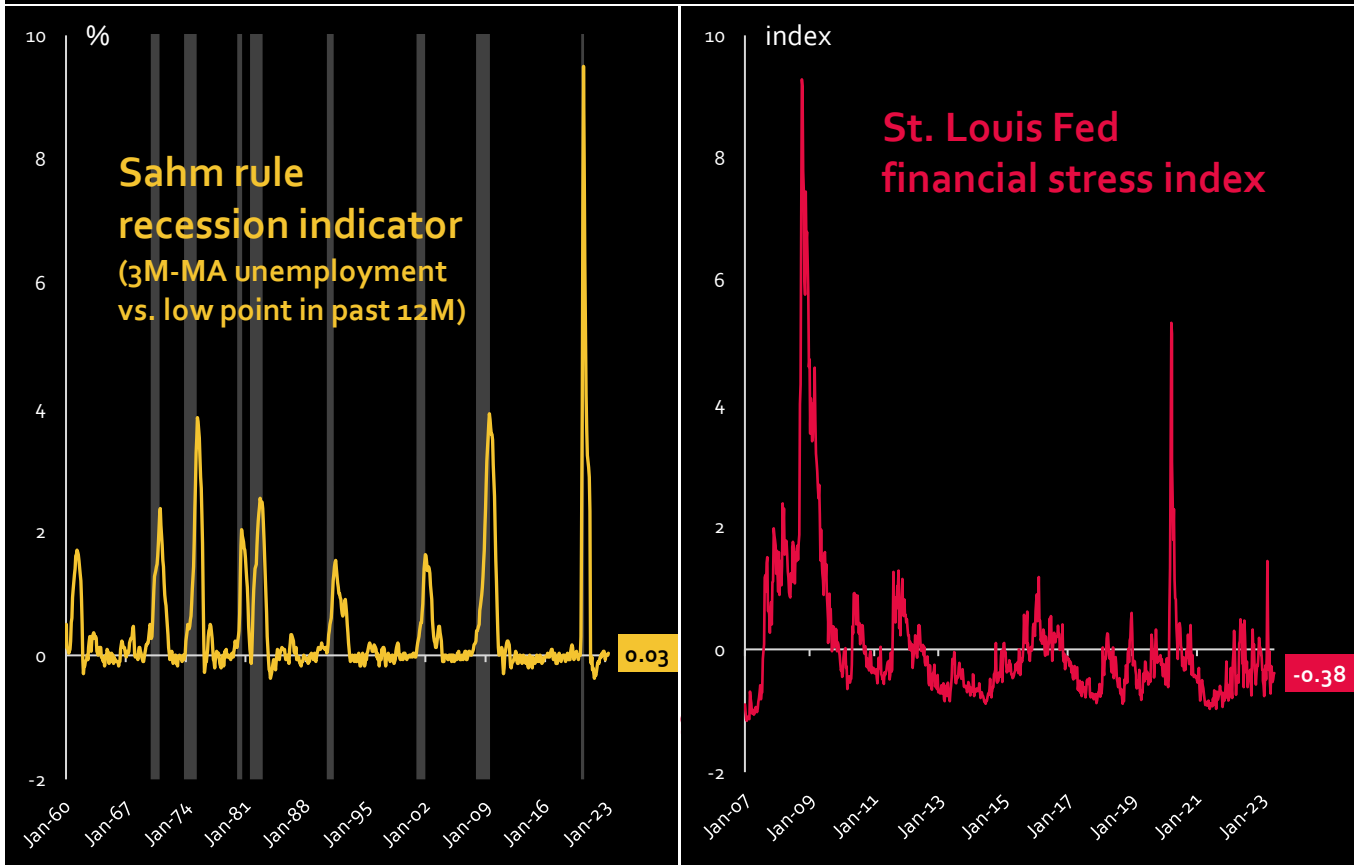
Source: Bloomberg, calculations by BCA Economist

**Chart 2. ... while a composite of leading economic indicators suggests a "dotcom bust"-sized recession to arrive by year-end ...**



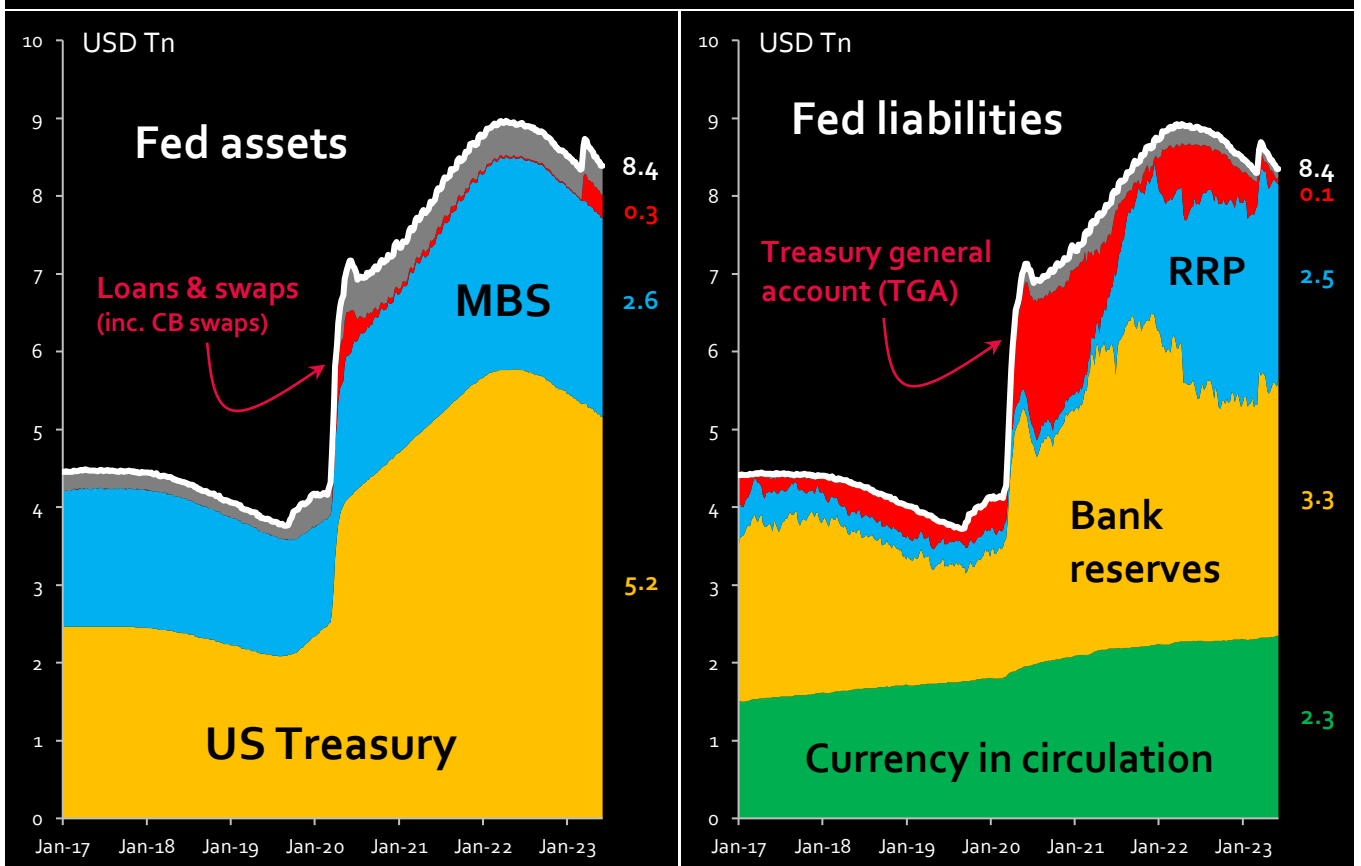
Source: Conference Board

**Panel 5. ... but the US job market is still at a very early stage of slowdown, while financial stress has actually moderated following recent banking crises**



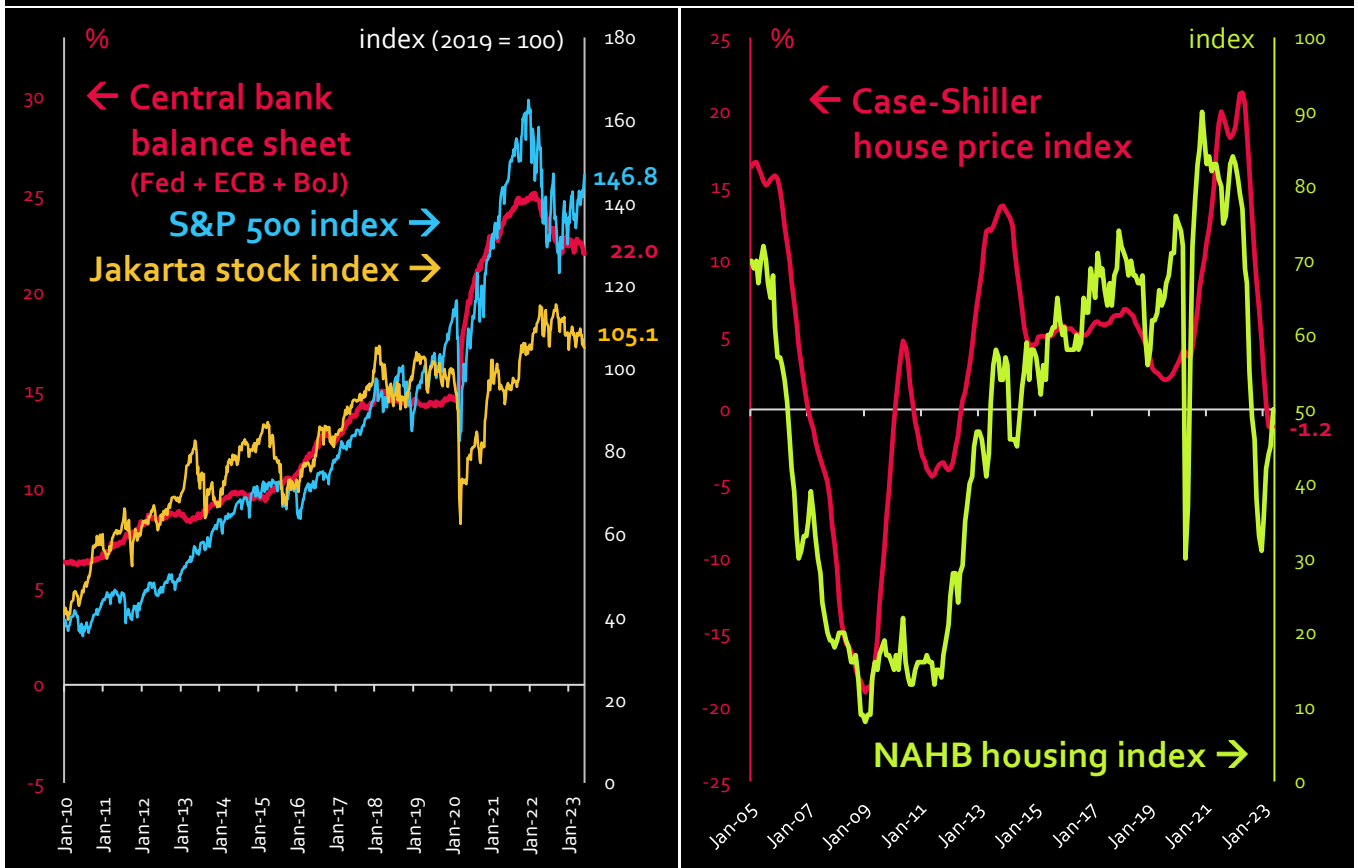
Source: St. Louis Fed

**Panel 6. QT marches on while Fed opens temporary loan facilities to handle the banking crisis, and simultaneous TGA refill could drain bank reserves and/or RRP**



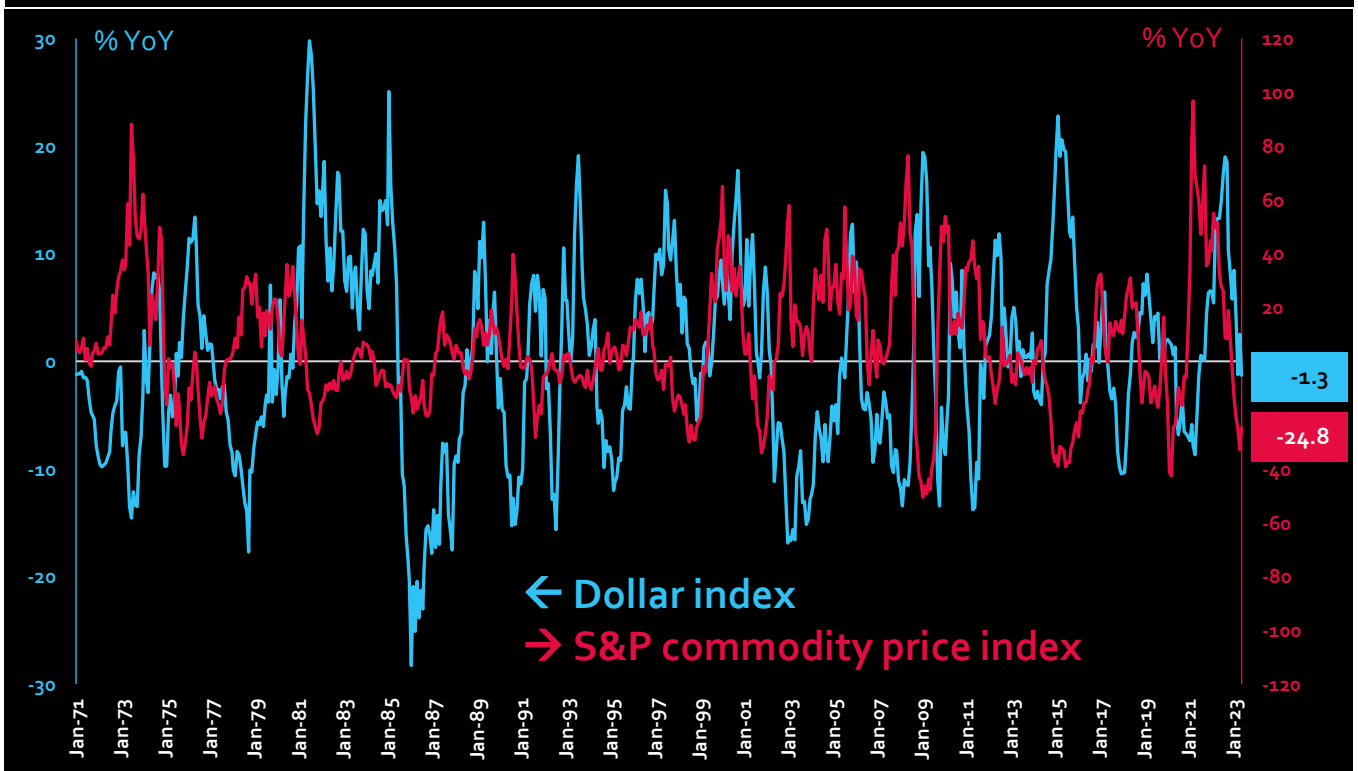
Source: St. Louis Fed

**Panel 7.** Some irrational exuberance seems to have crept back into US equities and housing, even as Fed (and other CB) balance sheets staying flat in recent months



Source: Bloomberg, calculations by BCA Economist

**Chart 3.** Commodity prices have moved decidedly south, while USD is in flux as the Fed is at an inflection point



Source: Bloomberg



## Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	15-Jun	-1 mth	Chg (%)
US	5.25	Jun-23	1.25	Baltic Dry Index	1,094.0	1,522.0	-28.1
UK	4.50	Jun-23	-4.20	S&P GSCI Index	548.0	546.4	0.3
EU	4.00	Jun-23	-2.10	Oil (Brent, \$/bbl)	75.7	75.2	0.6
Japan	-0.10	Jan-16	-3.60	Coal (\$/MT)	156.4	179.6	-12.9
China (lending)	4.35	Jun-23	4.15	Gas (\$/MMBtu)	2.05	2.25	-8.9
Korea	3.50	May-23	0.20	Gold (\$/oz.)	1,958.0	2,016.5	-2.9
India	6.50	Jun-23	2.25	Copper (\$/MT)	8,556.0	8,218.3	4.1
Indonesia	5.75	May-23	1.75	Nickel (\$/MT)	22,901.0	21,484.8	6.6
Money Mkt Rates	15-Jun	-1 mth	Chg (bps)	CPO (\$/MT)	755.6	852.5	-11.4
SPN (1M)	4.22	4.93	-70.8	Rubber (\$/kg)	1.31	1.36	-3.7
SUN (10Y)	6.28	6.41	-12.9	External Sector	May	Apr	Chg (%)
INDONIA (O/N, Rp)	5.59	5.58	1.2	Export (\$ bn)	21.72	19.28	12.61
JIBOR 1M (Rp)	6.40	6.40	-0.4	Import (\$ bn)	21.28	15.35	38.65
Bank Rates (Rp)	Mar	Feb	Chg (bps)	Trade bal. (\$ bn)	0.44	3.94	-88.91
Lending (WC)	8.95	8.89	6.13	Central bank reserves (\$ bn)*	139.3	144.2	-3.38
Deposit 1M	4.20	4.18	2.24	Prompt Indicators	May	Apr	Mar
Savings	0.69	0.67	1.92	Consumer confidence index (CCI)	128.3	126.1	123.3
Currency/USD	15-Jun	-1 mth	Chg (%)	UK Pound	0.782	0.798	2.04
UK Pound	0.782	0.798	2.04	Euro	0.914	0.920	0.65
Euro	0.914	0.920	0.65	Japanese Yen	140.3	136.1	-2.97
Japanese Yen	140.3	136.1	-2.97	Chinese RMB	7.121	6.952	-2.38
Chinese RMB	7.121	6.952	-2.38	Indonesia Rupiah	14,945	14,800	-0.97
Indonesia Rupiah	14,945	14,800	-0.97	Manufacturing PMI	May	Apr	Chg (bps)
Capital Mkt	15-Jun	-1 mth	Chg (%)	USA	46.9	47.1	-20
JCI	6,713.8	6,711.7	0.03	Eurozone	44.8	45.8	-100
DJIA	34,408.1	33,348.6	3.18	Japan	50.6	49.5	110
FTSE	7,628.3	7,777.7	-1.92	China	50.9	49.5	140
Nikkei 225	33,485.5	29,626.3	13.03	Korea	48.4	48.1	30
Hang Seng	19,828.9	19,971.1	-0.71	Indonesia	50.3	52.7	-240
Foreign portfolio ownership (Rp Tn)	May	Apr	Chg (Rp Tn)				
Stock	2,738.1	2,789.1	-51.06				
Govt. Bond	822.7	822.7	0.00				
Corp. Bond	11.8	11.8	-0.01				

Source: Bloomberg, BI, BPS

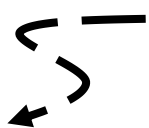
Notes:

^Data for January 2022

\*Data from earlier period

\*\*For changes in currency: **Black** indicates appreciation against USD, **Red** otherwise

\*\*\*For PMI, **>50** indicates economic expansion, **<50** otherwise



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## Indonesia – Economic Indicators Projection

	2018	2019	2020	2021	2022	2023E
Gross Domestic Product (% YoY)	5.2	5.0	-2.1	3.7	5.3	5.0
GDP per Capita (US\$)	3927	4175	3912	4350	4784	5285
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	3.4
BI 7 day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	5.75
USD/IDR Exchange Rate (end of year)**	14,390	13,866	14,050	14,262	15,568	15,173
Trade Balance (US\$ billion)	-8.5	-3.2	21.7	35.3	54.5	35.3
Current Account Balance (% GDP)	-3.0	-2.7	-0.4	0.3	1.0	-0.7

\*Estimated number

\*\* Estimation of Rupiah's fundamental exchange rate

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