FOMC:
Along for the ride

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Executive Summary

- The Fed issued a more hawkish forward guidance (only one cut this year), but market reaction has been mildly bullish owing to the decline of US inflation in May.
- We reserve skepticism that US inflation would decline fast enough to allow the Fed to cut early, given still-elevated "supercore" inflation and the strong job market, which continues to boost wage growth.
- For the Fed to cut this year, US unemployment would have to rapidly increase, which contrasts with the market's optimism that there may not be a "hard landing" ahead.
- The USD is likely to remain volatile and reasonably strong, complicating BI policy to maintain the IDR especially amid Indonesia's growing saving-investment imbalance.
- BI may hike by another 25 bps this year, but the timing is highly uncertain. Concerns about growth, expectations of a future Fed rate cut, and the use of other strategies (SRBI issuance and FX intervention) means that BI is reluctant to hike except under extreme circumstances.

- The Fed announced no significant change in their policies, but the market's eyes were firmly on the future anyways – specifically September and December. As it were, the probability of rate cuts at those two meetings increased slightly from 49% and 67%, respectively, towards 57% and 76%.

- It seems that the market put more stock on the declining US inflation rate than the Fed's own more-hawkish projections. The FOMC now sees only one rate cut in 2024 (vs. three in March), and it increased its annual inflation outlook from 2.4% to 2.6% (for core inflation: 2.6% to 2.8%).

- So which one is correct? Until further data, we cannot see the May inflation report as decisive progress towards the Fed's 2% target, as disinflation continues to be driven primarily core goods, which is a function of China's excess supply.

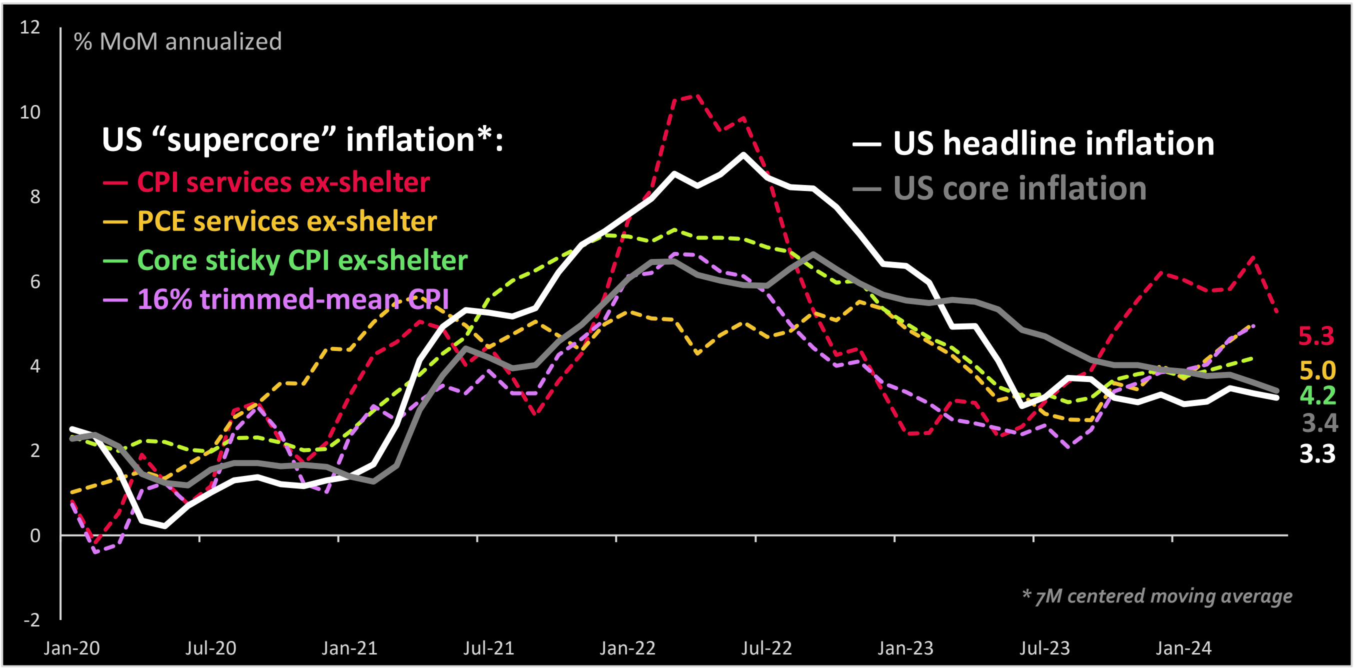
- And while there is a decline in services inflation ex-shelter, it merely brings this particular measure in line with other "supercore" inflation measures. As a whole, "supercore" inflation remains ahead of headline and core inflation – not a good sign since the former typically leads the latter two (***Chart 1***).

- There is, of course, a good argument that the US economy would slow moderately this year, as we outlined in [our recent deep dive on the US economy](). Excess savings have evaporated, while the tax-loss harvesting effect from 2023 has also disappeared.

- The main hurdle for a Fed rate cut, then, comes mainly from the supply-side, namely energy and wages (the main cost component for services). And since energy price, inflation, and unemployment rates are entangled as we wrote before (***Chart 2***), there would have to be a significant increase in job loss over the coming months – which would certainly help suppress wages – for the Fed to begin cutting in Q4-24.

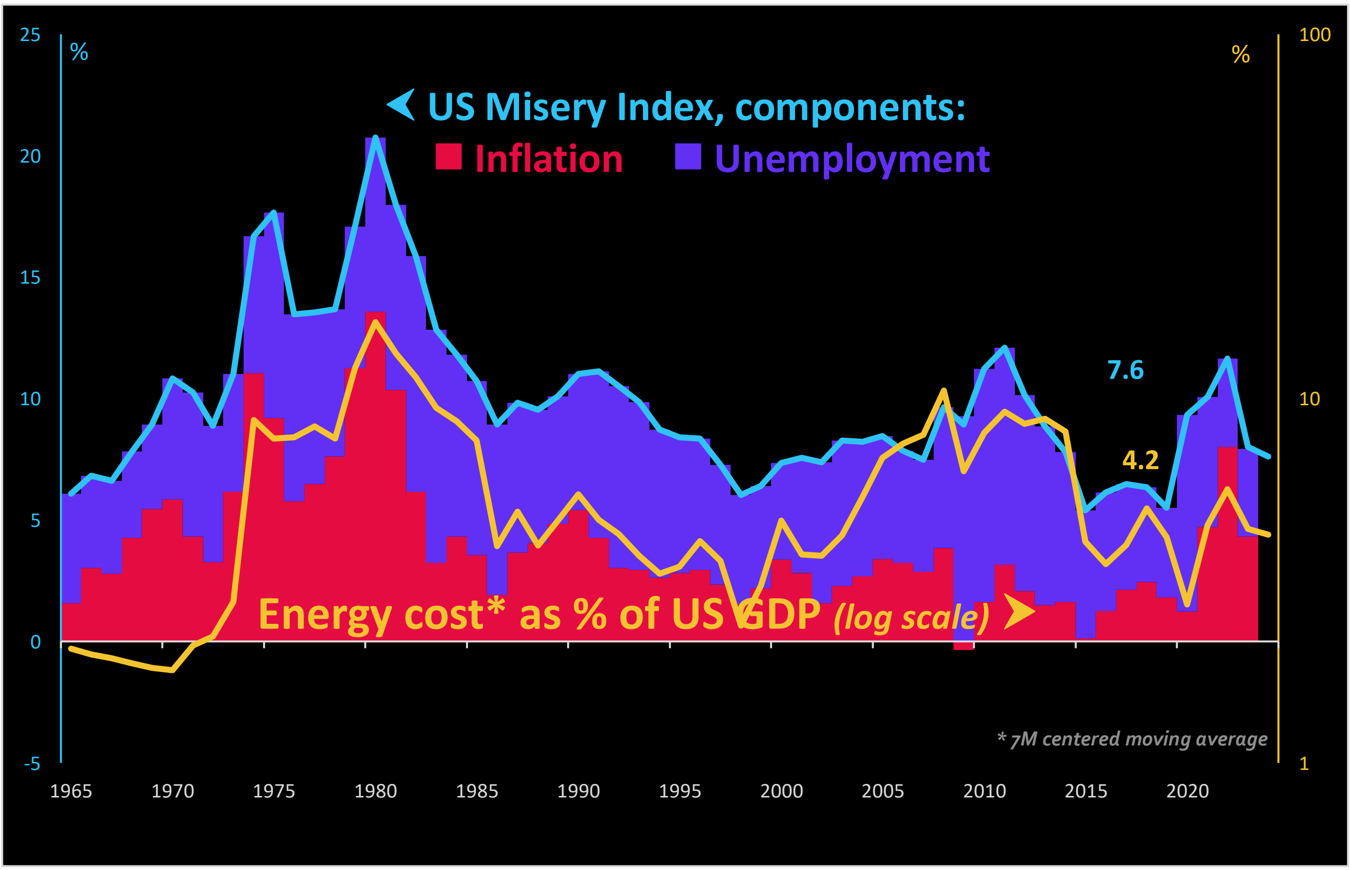
- Roughly speaking, with current WTI prices at USD 75 – 80/barrel, it would take an unemployment rate of about 5.2 – 6.0% to bring headline inflation down to 2.6%. The problem is, such a rapid momentum of job loss (from the current 4.0%) is usually associated with the start of a recession.
- The market's optimistic bet on 1 – 2 rate cuts this year, then, may not exactly square with its expectation of a US recession, which (according to Bloomberg survey) currently stands at just 30% and falling. And for a data-dependent Fed, there would need to be a lot more data to digest before it commits to a pivot.
- For Indonesia, this is not a comfortable situation to be in, and the Dollar's modest decline (-0.4% in the past two days) is unlikely to mark the start of a significant weakening cycle. The Rupiah is still strapped in to a roller-coaster ride, especially given broadening imbalance between domestic saving and borrowing (particularly FX borrowing), which we will cover in an upcoming report.
- The scale of this imbalance is approaching those in 2018 and 2022 (although not 2013). Both these episodes ended with a BI rate hike cycle, and a permanent shift of the Rupiah to a weaker level vis-à-vis USD.
- The difference, of course, is that those episodes occurred when the market expected tighter Fed policy, whereas now we are looking forward to a Fed rate cut. For this reason – and also given concerns over slowing domestic demand – we think that BI would be reluctant to raise rates, except under extreme circumstances.
- As such, we maintain room for potentially another 25 bps hike (year-end BI Rate at 6.50%), but the timing of that hike is strictly TBD. The chance of a hike in the next BI meeting (June 20th) may be limited by the significant inflows into SRBI since early May, which has bolstered its FX reserves and enabled it to maintain the Rupiah below 16,300 amid the pre-FOMC pressure. And given the mild euphoria (so far) that followed the FOMC, there might even be room for a brief Rupiah rally, which would further disincentivize BI against hiking prematurely.

Chart 1. Services inflation ex-shelter declined in May, but measures of "supercore" inflation remains ahead of headline and core inflation, possibly signalling future pressure



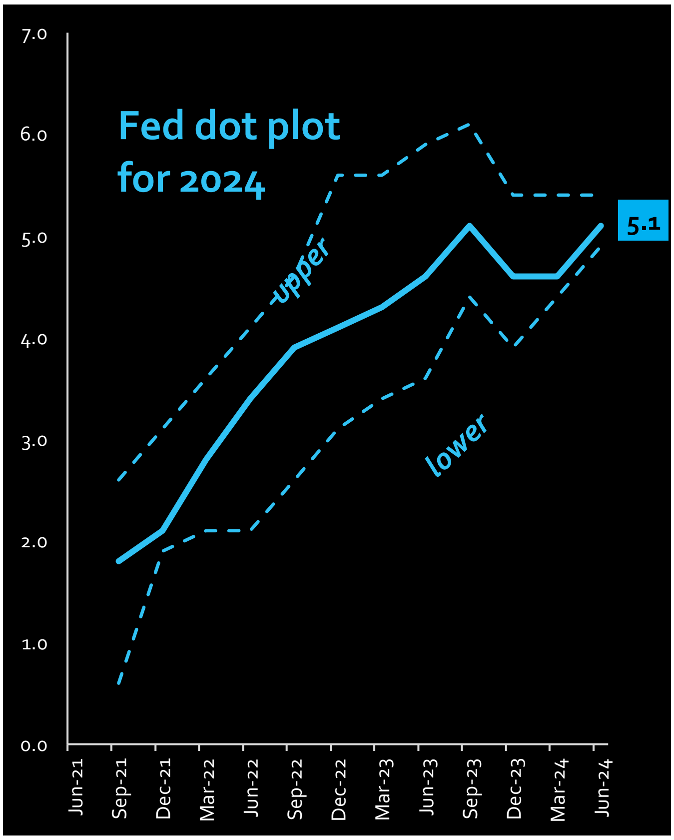
Source: *BLS, St. Louis Fed, Atlanta Fed, BCA Economist*

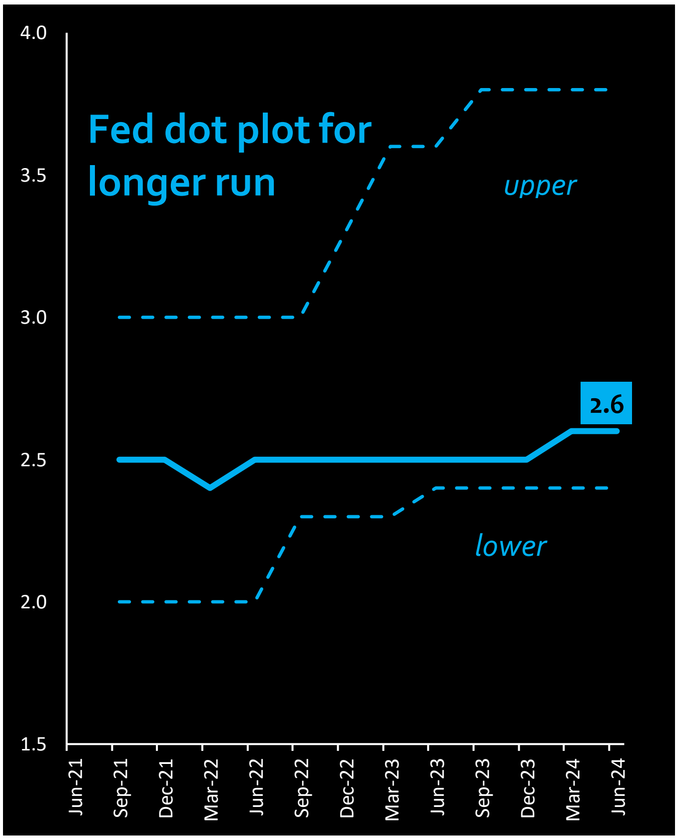
Chart 2. Energy prices has been moderating but not falling further, which limits the room for further disinflation without a significant increase in unemployment



Source: *BLS, St. Louis Fed, Atlanta Fed, BCA Economist*

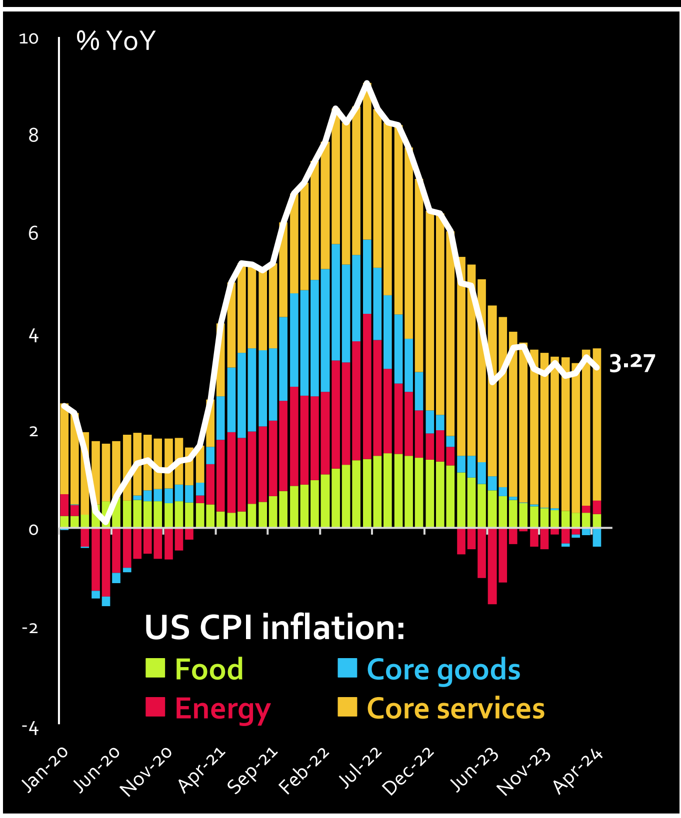
***Panel 1.* The Fed dot plot shows ever-slimmer probability of a rate cut this year (only once), and even long-run projections have become more hawkish**

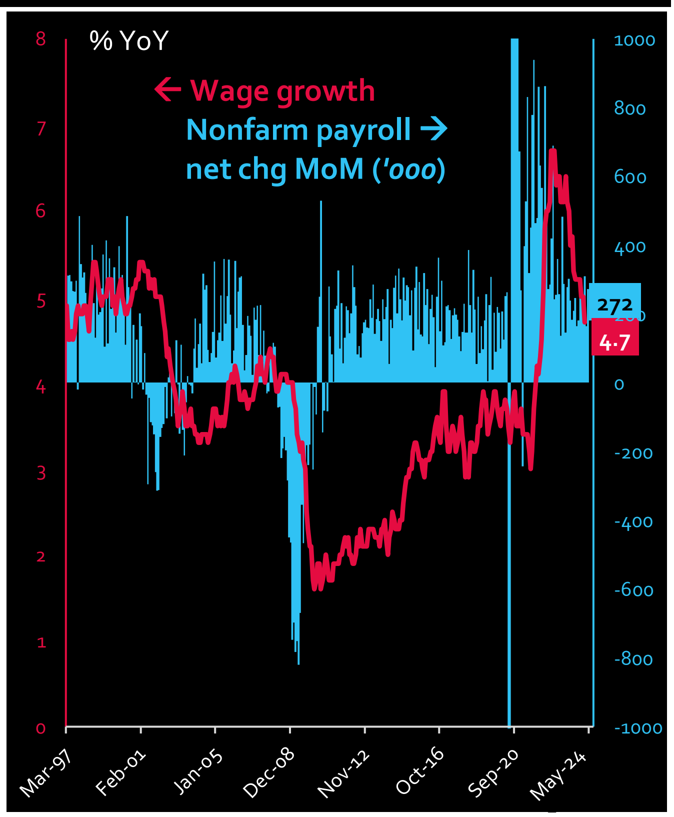




Source: Federal Reserve

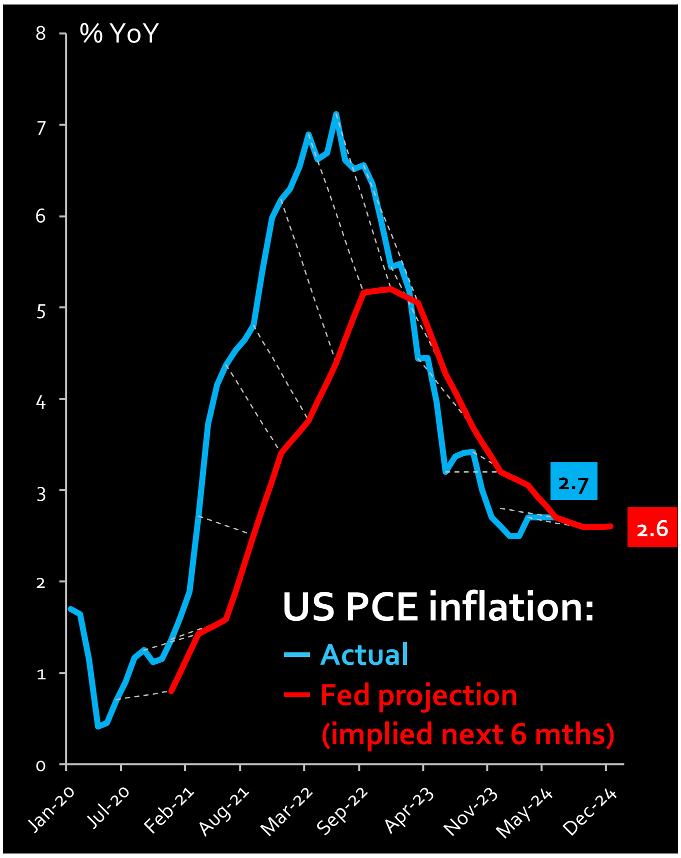
***Panel 2.* Services inflation has remained elevated despite continued disinflation in core goods, while payroll gains have remained quite solid**

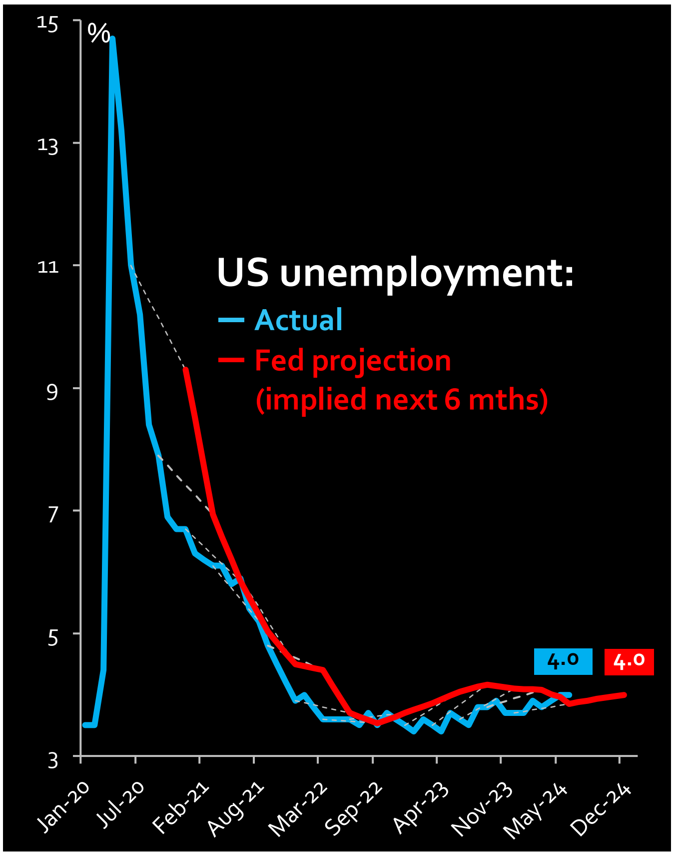




Source: US BLS, Bloomberg

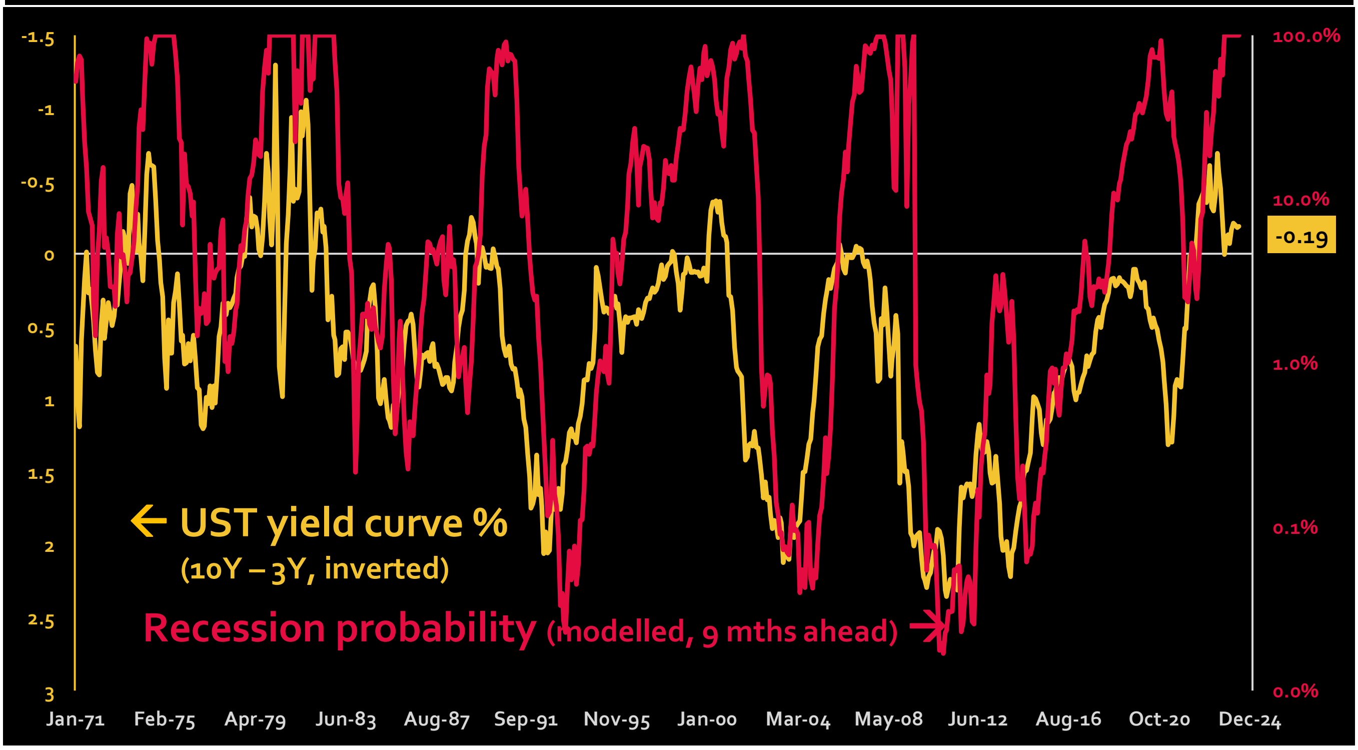
Panel 3. The Fed was caught flat-footed in 2021-22, but recently its projections for inflation and unemployment have been closer to the mark





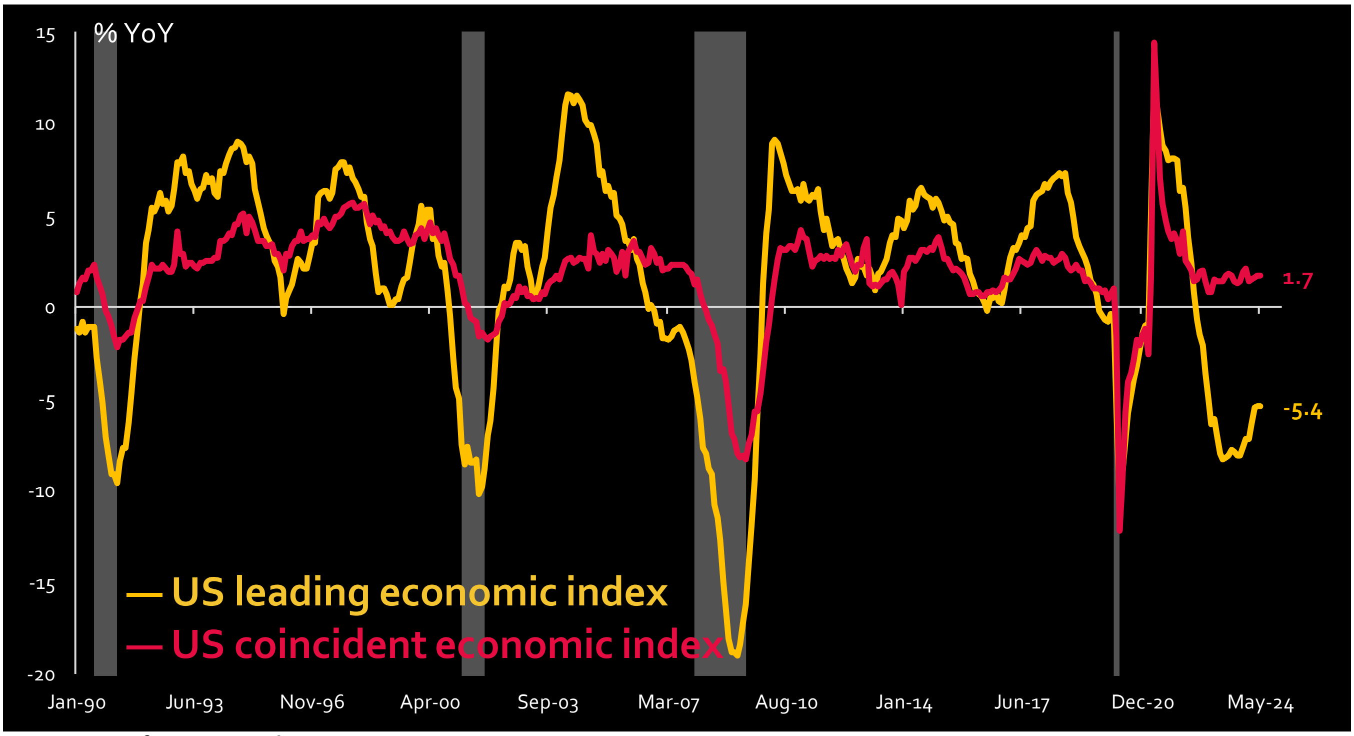
Source: Bloomberg, Federal Reserve

Chart 3. The US government strategy to issue more short-term Treasury Bills has skewed the yield curve, which now no longer functions as recession signal



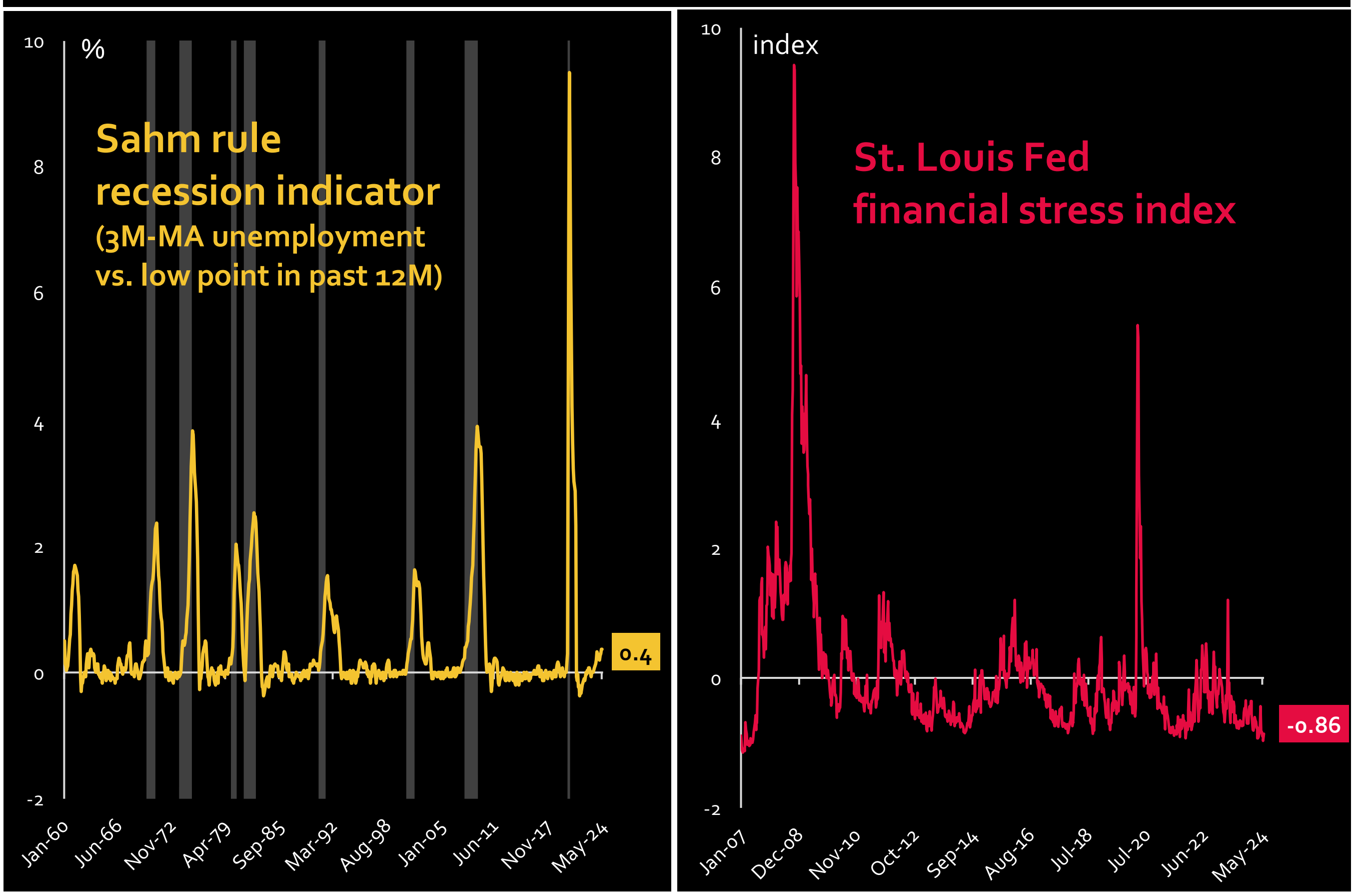
Source: Bloomberg, calculations by BCA Economist

Chart 4. **While LEI also failed to predict inflation, its recent (slight) recovery may signal improved activities in the US, especially in manufacturing industries**



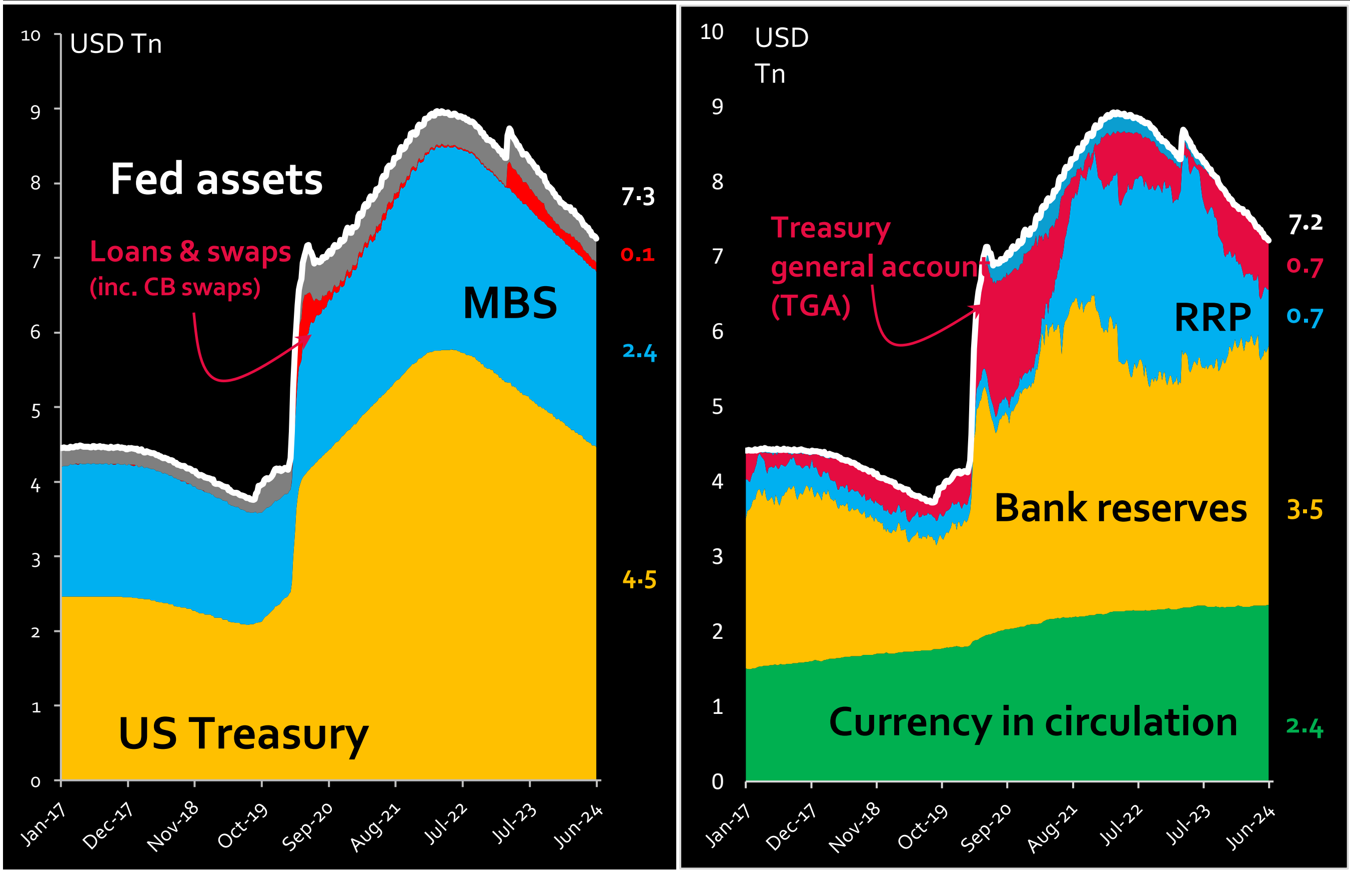
Source: Conference Board

Panel 4. **Sign of impending recession still limited, job loss momentum has not accelerated**



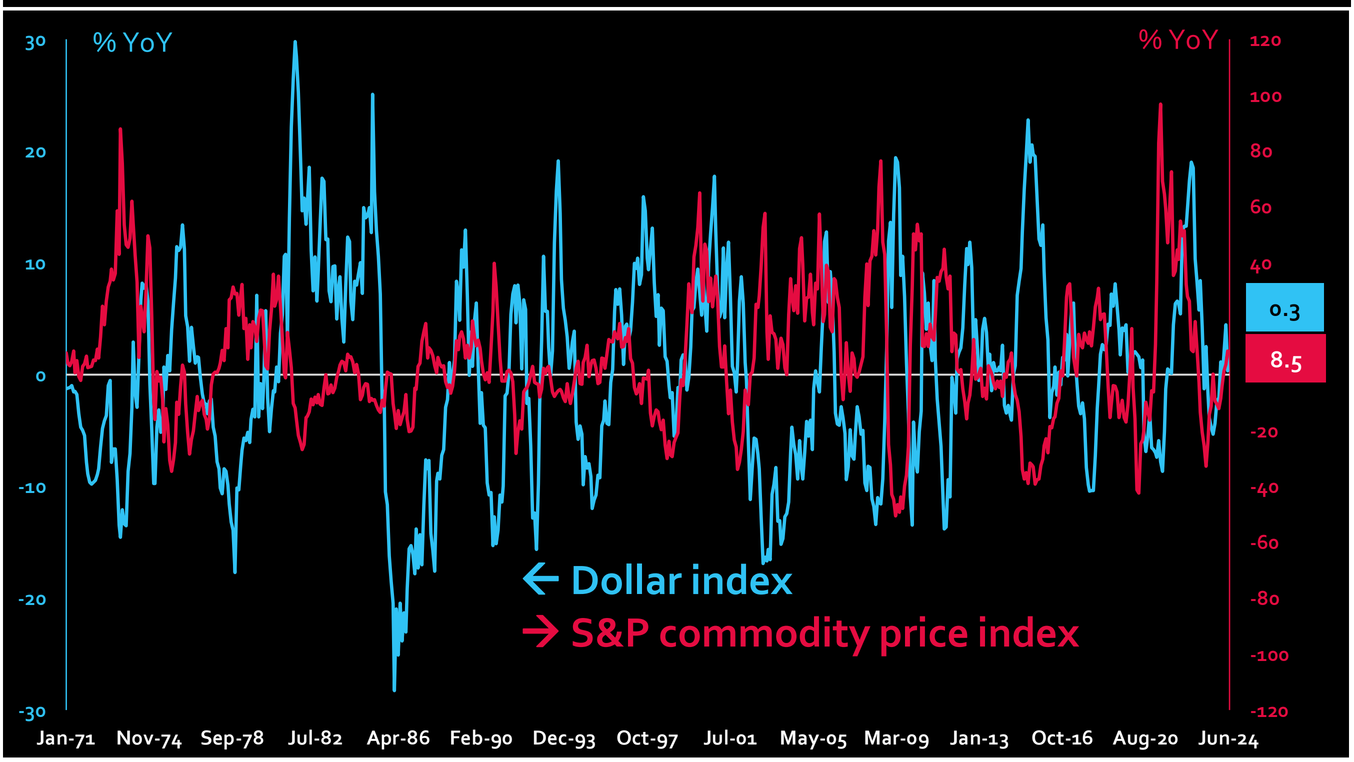
Source: St. Louis Fed

Panel 5. The Fed is slowing down its quantitative tightening (QT) with still-enlarged balance sheet, but sufficient liquidity buffers all-around



Source: St. Louis Fed

Chart 5. The USD remains strong but is stabilizing, but the gains in commodity prices have also been quite limited



Source: Bloomberg

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	5.50	Jul-23	2.20
UK	5.25	Aug-23	2.95
EU	4.25	Jul-23	1.65
Japan	-0.10	Jan-16	-2.60
China (lending)	2.50	Aug-23	4.05
Korea	3.50	Jan-23	0.80
India	6.50	Feb-23	1.75
Indonesia	6.25	Apr-24	3.41

Money Mkt Rates	12-Jun	-1 mth	Chg (bps)
SPN (1M)	5.88	5.80	7.6
SUN (10Y)	7.01	6.95	6.6
INDONIA (O/N, Rp)	6.02	6.40	-37.2
JIBOR 1M (Rp)	6.90	6.90	0.0

Bank Rates (Rp)	Mar	Feb	Chg (bps)
Lending (WC)	8.83	8.84	-1.69
Deposit 1M	4.62	4.62	-0.76
Savings	0.68	0.67	0.26

Currency/USD	12-Jun	-1 mth	Chg (%)
UK Pound	0.781	0.798	2.18
Euro	0.925	0.928	0.35
Japanese Yen	156.7	155.8	-0.60
Chinese RMB	7.241	7.227	-0.19
Indonesia Rupiah	16,295	16,045	-1.53

Capital Mkt	12-Jun	-1 mth	Chg (%)
JCI	6,850.1	7,088.8	-3.37
DJIA	38,712.2	39,512.8	-2.03
FTSE	8,215.5	8,433.8	-2.59
Nikkei 225	38,876.7	38,229.1	1.69
Hang Seng	17,937.8	18,963.7	-5.41

Foreign portfolio ownership (Rp Tn)	May	Apr	Chg (Rp Tn)
Stock	3,115.0	3,294.9	-179.85
Govt. Bond	807.0	789.9	17.11
Corp. Bond	8.2	8.4	-0.20

Trade & Commodities	12-Jun	-1 mth	Chg (%)
Baltic Dry Index	1,836.0	2,129.0	-13.8
S&P GSCI Index	576.5	577.2	-0.1
Oil (Brent, $/brl)	82.6	82.8	-0.2
Coal ($/MT)	135.5	144.0	-5.9
Gas ($/MMBtu)	2.80	2.14	30.8
Gold ($/oz.)	2,325.0	2,360.5	-1.5
Copper ($/MT)	9,821.0	9,897.5	-0.8
Nickel ($/MT)	17,808.7	18,780.3	-5.2
CPO ($/MT)	842.1	813.5	3.5
Rubber ($/kg)	1.79	1.61	11.2

External Sector	Apr	Mar	Chg (%)
Export ($ bn)	19.62	22.54	-12.97
Import ($ bn)	16.07	17.96	-10.55
Trade bal. ($ bn)	3.55	4.58	-22.46
Central bank reserves ($ bn)*	136.2	140.4	-2.97

Prompt Indicators	May	Apr	Mar
Consumer confidence index (CCI)	125.2	127.7	123.8
Car sales (%YoY)	-13.3	-17.5	-26.2
Motorcycle sales (%YoY)	-4.5	18.3	-7.8

Manufacturing PMI	May	Apr	Chg (bps)
USA	51.3	50.0	130
Eurozone	47.3	45.7	160
Japan	50.4	49.6	80
China	51.7	51.4	30
Korea	51.6	49.4	220
Indonesia	52.1	52.9	-80

Source: Bloomberg, BI, BPS
Notes:
*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

	2019	2020	2021	2022	2023	2024E
Gross Domestic Product (% YoY)	5.0	-2.1	3.7	5.3	5.0	5.0
GDP per Capita (US$)	4175	3912	4350	4784	4920	5149
Consumer Price Index Inflation (% YoY)	2.7	1.7	1.9	5.5	2.6	3.2
BI 7 day Repo Rate (%)	5.00	3.75	3.50	5.50	6.00	6.50
USD/IDR Exchange Rate (end of year)**	13,866	14,050	14,262	15,568	15,397	16,304
Trade Balance (US$ billion)	-3.2	21.7	35.3	54.5	37.0	32.6
Current Account Balance (% GDP)	-2.7	-0.4	0.3	1.0	-0.1	-0.5

*Estimated number

** Estimation of Rupiah's fundamental exchange rate

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