Doubling down on the dots

By Taylor Schleich, Jocelyn Paquet, Warren Lovely

For the second consecutive meeting, the FOMC voted to raise the target range for the federal funds rate by 75 basis points to 2.25% to 2.50%. Unlike in June, there were no dissenters in the vote for 75 bps. Meanwhile, the interest rate paid on reserve balances will be raised by a proportional 75 basis points to 2.40%. The statement also confirmed that quantitative tightening will continue as previously outlined.

Elsewhere, statement changes were kept to a minimum. The only notable change came in the discussion of economic activity. Consistent with what should be a weak Q2 GDP report released tomorrow, the statement noted: “Recent indicators of spending and production have softened.” (Previously: “Overall economic activity appears to have picked up after edging down in the first quarter”). As an offset to the weaker growth backdrop, the statement reiterated that “job gains have been robust in recent months”. For completeness, we’d note the FOMC also axed the following line from its statement: “COVID-related lockdowns in China are likely to exacerbate supply chain disruptions.”

Press conference

On balance, the press conference was far more hawkish than we’d expected. While market pricing for Fed policy has dropped significantly since mid-June, Chair Powell noted that June’s dot plot is still the “best estimate of the Committee’s thinking” (including 2023 hikes). While Powell kept alive hopes for a soft landing, he conceded that the path to this outcome ‘has narrowed and may narrow further’. Additionally, he bluntly stated growth needs to slow and the job market needs to soften. These outcome “are likely necessary to restore price stability”. Despite what could be two consecutive quarters of negative GDP growth, Powell and the FOMC don’t think the U.S. economy is in recession, as the labour market is still very strong. Moreover, he noted that there have been a “number of times” where growth was slow (or negative) and the labour market remained strong and “the economy has gone right through that and been fine.”

As for what to expect next meeting, Powell provided far less definitive guidance than in June. “Another unusually large rate increase could be appropriate [in September] but that is a decision that will depend on the data we get between now and then.” Indeed, he conceded that decisions will be made on a meeting-by-meeting basis and the Fed should not provide the “clear guidance” they had on the way to neutral”. It does appear, however, that we could at least move away from these 75 basis point moves soon: “As the stance of policy tightens further, it likely will become appropriate to slow the pace of increases while we assess how our cumulative policy adjustments are adjust the economy and inflation”. He added, “the full effect of rate hikes has not been felt by the economy” and “significant additional tightening is in the pipeline”. Over the medium-term, what might ultimately allow the Fed to declare victory? They’ll need to see “compelling evidence” that inflation is moving down.

Bottom line

There were no surprises here on the key rate decision as the FOMC delivered on the 75 basis point hike anticipated by markets and economists alike. As for the statement, aside from a slight negative change to the characterization of economic activity, there wasn’t anything notable that changed from June. The forward guidance from last statement “that ongoing increases in the target range will be appropriate” remained intact.

With the Fed only now getting to what many would consider a neutral rate, there’s still some further tightening that needs to be done to at least move rates into slightly restrictive territory. It’s clear (for now) that the Fed thinks the American economy will be able to withstand higher rates, which would suggest the aggressive path for rates outlined in the June dot plot rate is still more or less their base case (3.50% fed funds upper bound target by the end of the year and close to 4% next year). Indeed, Powell fully admitted this in his press conference which, in our view, came across as hawkish. Powell was largely dismissive of deteriorating soft data and GDP weakness, instead pointing to a still-strong labour market. It’s clear that inflation remains public enemy number one for the FOMC, and until they see ‘compelling evidence’ that price pressures are diminishing, they won’t feel comfortable taking their foot off the brake. Powell aid at least concede that the pace of rate hikes could slow in the future but certainly didn’t take a 75 basis point move off the table. In our view, the next two months of inflation data will be critical in determining the size of a September hike. At this stage, we view 50 basis points as most likely.

Overall, we’d concede that the path to our forecast for a 3% fed funds terminal rate is a narrow one, particularly after what we heard from Chair Powell today. That said, we do believe a significant deterioration in economic data and an easing in price pressures between now and November (the Fed’s next meeting after September) could still prompt a Fed pause. Certainly, a technical recession in the first half of the year that could be confirmed tomorrow would help on this front. More importantly, a major deceleration in the pace of job creation (or outright job losses) will be needed. And we do have hope that this will come based on rising jobless claims, anecdotal evidence of hiring freezes/layoffs among businesses and the decline in employment in June’s household survey. But most importantly, we’ll need to see progress made on inflation. We believe that June’s report will represent the peak of inflation for the cycle and three straight declining prints before November might just be the compelling evidence the Fed is looking for. But like Powell’s assessment of the chances for a soft landing, the path here is narrowing.

The next monetary policy meeting will take place September 20th-21st.
Fed’s statement:

Recent indicators of spending and production have softened. Nonetheless, job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher food and energy prices, and broader price pressures.

Russia’s war against Ukraine is causing tremendous human and economic hardship. The war and related events are creating additional upward pressure on inflation and are weighing on global economic activity. The Committee is highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 2-1/4 to 2-1/2 percent and anticipates that ongoing increases in the target range will be appropriate. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve’s Balance Sheet that were issued in May. The Committee is strongly committed to returning inflation to its 2 percent objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee’s goals. The Committee’s assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michael S. Barr; Michelle W. Bowman; Lael Brainard; James Bullard; Susan M. Collins; Lisa D. Cook; Esther L. George; Philip N. Jefferson; Loretta J. Mester; and Christopher J. Waller.
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