Fed poised to hike slower... but not lower

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As expected, the U.S. Federal Reserve increased the target range for federal funds rate by 75 bps to 3.75-4.00% and will continue to reduce its holdings of Treasuries and MBS. The interest rate on reserve balances increased a proportional 75 bps to 3.90%. There were no dissenters in today’s decision. This is the Fed’s fourth successive 75 bp hike and the sixth move in total, bringing cumulative policy rate tightening to 375 bps (with more set to come).

Parsing the statement, you won’t find any changes to the characterization of the economy. There is ‘modest’ growth in spending and production, while job gains have been ‘robust’. Echoing the prior statement(s), “inflation remains elevated” and the FOMC is “highly attentive to inflation risks”. And once more, the statement flags a strong commitment to return inflation to the Fed’s 2% objective. While much of the statement was a carbon copy of September there were some critical changes of note:

• The committee still anticipates that ongoing rate increases are appropriate, adding this is “in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time”

• Moreover, “in determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments”

Press conference

Suffice to say, there was an apparent discrepancy between the messaging in the rate statement and the messaging in the press conference. While the statement offered (what appeared to be) net dovish additions, Powell’s tenor in the presser was just as hawkish (if anything, more hawkish) than in the past. Yes, he acknowledged the lags with which policy operates and acknowledged associated uncertainty. But he also made it clear we’re not yet close to the terminal rate (“there’s some ground to cover”) and “it’s very premature to be thinking about pausing”. Powell went as far as to say that recent data is consistent with policy settings higher than those laid out in the September dot plot. The question, in Powell’s view, is shifting from “how fast do we need to move”, to “how high do we need to get” and “how long do we need to stay there”. In other words, the pace of tightening may shift down, but the ultimate policy rate destination and the time spent there could be any higher/longer. He did, however, acknowledge that there’s significant uncertainty around the terminal level.

In the past, we’ve heard Powell say that some softening in the labour market will be required. According to Powell today, “it’s not obvious that the labour market is softening materially”. Rather, “demand is substantially exceeding supply for workers”. When it comes to a Fed-engineered global recession (via USD appreciation), Powell pushed back: “price stability in the US is a good thing for the global economy”. He also clearly remains subscribed to the notion that risks of overtightening are less severe than the risks of under tightening: “If we overtighten, we can use our [powerful] tools to support the economy but [if we under tighten] then the risk is inflation becomes entrenched and the employment costs go up”. Finally, he admitted that the path to a soft landing has narrowed but he still believes achieving this is possible.

Bottom line

It was a tale of two acts today. Firstly, the rate statement seemingly struck a more pragmatic tone, with added language that appeared marginally dovish. Then came the press conference. In it, Chair Powell pushed back strongly against a near-term policy pivot, noting that there is still some ground to cover and “it’s very premature to be thinking about pausing”. In fact, the rate guidance the Fed had given in September might not be high enough. The seemingly mixed messaging sent markets running in circles, with a ~10 bp rally on the rate statement’s release reversing (and then some) by the end of the press conference. So how do we parse it all? Firstly, it’s abundantly clear that the Fed is not yet done. But, like we’ve seen from other central banks, decisions going forward may naturally become more finely balanced and they needn’t act with the same sense of urgency. That means a 50 bp rate hike in December could still materialize (our base case) but it doesn’t necessarily mean the Fed intends to tap out early or stop at a lower level than previously anticipated. Indeed, while we may get a downshift next month, it appears that the Fed will be inclined to hike for longer and to a higher level in early-mid 2023. There are six weeks of data before the next meeting (that could quickly change things) but at this point, we’d expect a higher terminal rate to be reflected in December’s dot plot.

All of that being said, the Fed’s core focus is clearly inflation. While that has remained stubbornly high this year, we retain some conviction that this will decelerate much faster than the Fed (or others expect) as we outlined in our Monthly Economic Monitor. If that materializes, we could relatively quickly see the Fed shift to easing by the end of next year. While we’re admittedly in a unique economic environment, rate cuts by the end of 2023 would be consistent with the historical record, as we laid out in our empirical study on past FOMC policy pivots. The next monetary policy meeting will take place December 13-14.
Fed’s statement (November 2, 2022):

Recent indicators point to modest growth in spending and production. 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 3-3/4 to 4 percent. The Committee anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. 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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