December 14, 2022

Fed still sees itself with more work to do

By Warren Lovely and Jocelyn Paquet

As fully expected, the U.S. Federal Reserve used its final scheduled decision of calendar 2022 to increase the target range for the federal funds rate by 50 basis points. The resulting target range for federal funds climbs to 4.25-4.5%, with cumulative policy rate tightening now amounting to 425 bps via seven consecutive hikes. The Fed will continue to reduce its holdings of Treasuries and MBS pursuant to a pre-existing program and subject to monthly caps for both Treasuries ($60 billion/month) and agency MBS ($35 billion/month). The interest rate on reserve balances increased an equivalent 50 bps to 4.4%. There were no dissenters in today's decision.

Notwithstanding the as-expected policy rate decision, there are some notable elements to today's decision. The 50 bp hike technically represents a downshift relative to the four preceding decisions, each of which involved the FOMC hiking by a more aggressive 75 bps a crack. Still, the FOMC retained its warning that additional hikes will be needed. On the forward guidance, the FOMC has consistently stated that "ongoing increases in the target range will be appropriate" since this tightening cycle kicked off in mid-March. That line was fully retained, as FOMC presumably felt it premature to let its guard down on inflation. When it comes to future increases in the target range, the FOMC will be guided by "the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments".

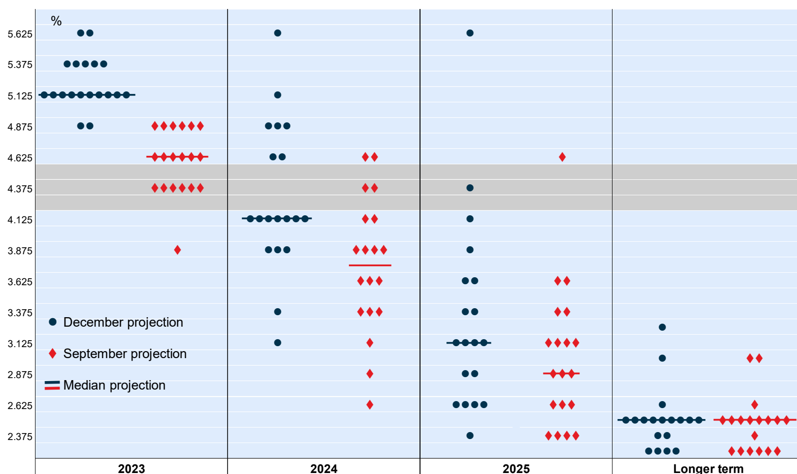
Further reflecting on the rate statement language, the characterization of the economy and inflation was unchanged vs. November 2nd. Specifically, spending/production growth is still characterized as "modest", while job gains "have been robust" and the unemployment rate "remained low". Inflation remains "elevated", with the statement continuing to point to pandemic-related imbalances, higher food and energy prices and "broader price pressures". As such, the FOMC is "highly attentive to inflation risks".

Summary of Economic Projections

One of the key focuses leading up to today's statement was the Fed's updated dot plot. With Chairman Powell having flagged in recent communications that he expected the terminal rate to be higher compared to September's projection, the increase in the median rate anticipated by FOMC members at the end of 2023 (from 4.625% to 5.125%) did not come as a surprise per se but was probably a bit more aggressive than many had planned. As for us, we were surprised to see so many policymakers increasing their 2023 projection despite some of them having adopted a more dovish tone in recent weeks. On a more distant horizon, policymakers still expected policy rates to drop, but less so than in their previous estimate. They saw policy rates go down to 4.125% at the end of 2024 (against 3.75% in the September dot plot) and 3.125% at the end of 2025 (against 2.875%). We could help but notice how widely dispersed the points are in the two most distant years of the dot plot, a sign of the high level of uncertainty surrounding these forecasts.

Moving on to the Summary of Economic Projections (SEP). Most analysts expected the Fed to boost its 2022 growth expectations given latest developments and that is precisely what it did, moving its Q4/Q4 GDP growth forecast from 0.2% to 0.5%. Perhaps more interesting was the downgrade to 2023's number, from +1.2% to +0.5%. This figure appears rather optimistic to us when compared to our own estimate for a contraction of 0.4%. (This divergence explains in large part why we anticipate FOMC members to underdeliver when it comes to rate hikes.)

U.S.: FOMC participants' assessment of appropriate monetary policy
Current target range: 4.25%-4.50% (grey area)



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FOMC: Summary of Economic Projections

	Latest	September projections
Change in real GDP (%)		
2022	**0.5**	0.2
2023	**0.5**	1.2
2024	**1.6**	1.7
2025	**1.8**	1.8
Long run	**1.8**	1.8
Unemployment Rate (%)		
2022	**3.7**	3.8
2023	**4.6**	4.4
2024	**4.6**	4.4
2025	**4.5**	4.3
Long run	**4.0**	4.0
PCE Inflation (%)		
2022	**5.6**	5.4
2023	**3.1**	2.8
2024	**2.5**	2.3
2025	**2.1**	2.0
Long run	**2.0**	2.0

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Despite a weaker growth path and a higher rate trajectory, the FOMC's 2023 inflation forecast was marked up from 2.8% to 3.1%. Although partly due to a higher starting point, this revision also hints at a loss of confidence on the part of FOMC members who now seem to think price pressures will prove harder to eradicate. We do not share this pessimism as we feel 425bps+ of hike will slow the economy enough to get inflation back under control.

Press conference

The Chair's opening remarks emphasized that while the FOMC had covered a lot of ground, there's more work to do, with restrictive policy settings likely to be needed for some time. While elements of the economy have weakened, Powell repeatedly emphasized that the U.S. labour market was still very, very tight (i.e., unemployment rate low, job vacancies elevated, wage growth strong). Labour markets are simply out of balance in their opinion and achieving a better balance will take time. On inflation, he noted that recent reports have ushered in welcome relief and give the Committee some confidence in the forecast for easing inflation. Still, headline and core CPI/PCE inflation is still far above their target and we need to be 'realistic' about the overall process of securing price stability. Risks to inflation likewise remain weighted to the upside. While inflation expectations remain well anchored, that's no reason for complacency in his opinion.

He argued that no one knows with any certainty where the economy is headed. Despite the more elevated dot plot, he was not willing to rule out a soft landing. He pushed back against the idea that the fresh SEP is a de facto recession forecast, noting that growth is still thought to be positive and the expected unemployment rate, while rising, would remain relatively low. He generally cautioned that recession risks are not knowable. He likewise cautioned that there is no precise understanding of where the so-called neutral rate resides. In response to a question about the FOMC's tolerance for economic pain, he countered that the greatest pain would ultimately come from letting inflation become entrenched by failing to act. Simply put, there is no painless way to restore price stability at this point.

On the policy rate setting, the FOMC has shifted its focus from the speed of increases, which at one point was considered the most important thing. As they've moved into legitimately restrictive territory, the level (as opposed to the speed) has now become more important… so too is the assessment of how long they will need to stay there. That speed is less important helps explain the downshift today (with the 50 bp hike still portrayed as a big move historically). He likewise conceded that as rates are now higher, it could become appropriate to probe the terminal level via smaller hikes, implicitly opening the door to 25 bp moves down the road. Saying all that, he underlined repeatedly that the FOMC feels rates are not yet restrictive enough and that more work needs to be done. He noted that 17 of 19 members contributing to the dots, have a 5% on their fed funds forecast for 2023. In his mind, the Committee won't contemplate easing policy until they are very confident that inflation is moving down towards their 2% target on a sustained basis. In this way, he was leaning against those who foresee a reasonably speedy pivot to less restrictive rates. More than once, he argued that the historical record cautions against premature easing.

He once again broke down the Fed's inflation assessment into three component parts. 1) Goods inflation is easing pretty quickly as supply chains have improved. (As an aside, he remarked that China rapidly evolving COVID situation was risky, but did not see developments in China as having a material impact on the U.S. outlook.) 2) Housing-related inflation remains very high and could well go up near term, but the FOMC is confident that as new leases are incorporated there will be some relief around mid-2023. 3) Non-housing core services is where the FOMC remains most focused, with this segment accounting for 55% of the inflation picture. It's here where labour markets are key and the FOMC's assessment is that labour market conditions remain very strong/tight. In his view, a substantial amount of time will be needed to bring labour market conditions into better balance, particularly with businesses seemingly reluctant to lay off workers. He raised the idea that the U.S. suffers from a 'structural labour shortage' but stopped short of offering policy recommendations to Congress (for example, on immigration policy).

He firmly rejected the idea of re-assessing the Fed's 2% inflation target. In Powell's view, it's simply not the time to be thinking about tweaking inflation goals and in the here-and-now there are no circumstances under which the FOMC would contemplate a different objective.

Bottom line

The U.S. Federal Reserve has generally done a good job guiding markets and today's decision on the target range (+50 bps) was fully expected. Saying that, the accompanying SEP/dot plot left the market with some net new information to digest. Notwithstanding yesterday's welcome relief on CPI, there's nothing particularly dovish here. Simply put, U.S. inflation remains uncomfortably high and far too removed from the FOMC's desired range. While the FOMC has downshifted in terms of the size of the latest move, the Committee is not yet prepared to enter into a more balanced and data dependent mode. Rather, the statement continues to flag that additional increases in the target range will be needed. The fresh dots offer important guidance here, as the median projection for fed funds (upper) has risen to 5.25% for the end of 2023 (vs. 4.75% in September). That implies that the majority of FOMC members feel another 75 bps of tightening would be appropriate before turning to less-restrictive policy settings in 2024. To be clear, the FOMC's thinking is likely to evolve in line with broader inflation developments. To us, the ongoing potential for more significant inflation relief in the second half of 2023 could ultimately lead to a re-think on the appropriate level for fed funds. But in the near-term at least, the FOMC is flagging its unified determination to tackle inflation and appears willing to tolerate the marginal economic pain that may be required to secure price stability.

Fed's statement (December 14, 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 contributing to 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 4-1/4 to 4-1/2 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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General

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