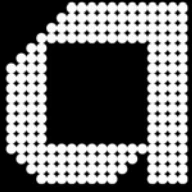

Research Institute - Insight

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#US / #Insight / #Monetary Policy

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Fed slows pace of hikes but delivers hawkish message

As expected, the Fed slowed the pace of its hiking cycle, with a 50bps increase. However, the broader signals were hawkish, with the dots showing a more restrictive path of policy through the forecast horizon. We continue to expect a further 50bps hike next year, before a cutting cycle commences by the end of 2023.

Key takeaways

- The Federal Reserve hiked the Fed Funds target rate range by 50bps to 4.25%-4.5%. The move was widely expected, and represents a step down in the pace of hikes compared to the 75bps moves at the last four FOMC meetings.
- The overall tone of communications was hawkish. The median dot shows rates at 5.125% at the end of next year, and then only a very modest cutting cycle for the rest of the forecast horizon.
- We continue to see a lower terminal target rate range of 4.75%-5%, as we think the economy will be in recession before the Fed can push rates much higher. However, near term demand side resilience, resulting in a later onset of recession, would create upside risk to our rate forecasts.
- The Fed's economic projections were more downbeat, with higher inflation and lower growth. While the forecasts increasingly recognise that "immaculate disinflation" is not possible, with a prolonged period of economic pain necessary to restore price stability, we think they are still too optimistic.
- As such, we continue to expect a much more significant rate cutting cycle from late 2023 than envisioned by the Fed or priced by markets.

50bps hike as expected but hawkish signals

As was widely expected, the US Federal Reserve stepped down its pace of tightening at the December FOMC meeting, hiking rates by 50bps after four consecutive hikes of 75bps. This takes the Fed Funds target rate range to 4.25%-4.5%. The overall tone of the forecasts and wider communication was hawkish.

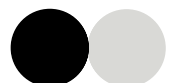
The median dot in the Summary of Economic Projections (SEP) now shows the Feds Funds target rate midpoint of 5.125% by the end of 2023. This is up 50bps compared to the September SEP. The Fed had been foreshadowing for some time that this meeting would see the dots move higher. Even so, the skew of dots was probably higher than the market had been expecting.

We are minded to downplay the signal from the dots at the moment, and instead continue to expect a terminal target range of 4.75%-5%. This is because we think the Fed will deliver one more 50bps hike in February, before the economy then starts to slow rapidly. With our forecasts showing the US in recession in Q2 next year, we do not see the Fed following through on these putative further rate hikes.

However, we acknowledge that there are upside risks to our forecasts. Should the demand side of the economy prove more resilient than we expect in the near term, with households in particular benefitting from healthier balance sheets and a high stock of liquid assets, the US economy may not fall into recession until the second half of next year.

Were this to happen, this would provide the time (and rationale) for the Fed to keep tightening beyond the February FOMC meeting.

In that case, rates could even exceed the Fed's own median dot forecast. As such, we think near term demand data is a better waymark of the likely terminal rate than Fed



communication. However, we continue to emphasise that the demand side is not the right place to look for signs of an eventual soft landing.

Fed is forecasting higher inflation and lower growth

The rest of the SEP forecasts represented a more downbeat view on the economy. The Fed sees significantly more inflation pressure over the next two years than it did in September. It now forecasts core PCE at 3.5% at the end 2023 (vs 3.1% in September) and at 2.5% at the end of 2024 (vs 2.3% in September).

Interestingly, the inflation news since the September meeting has arguably been encouraging, with the last two CPI reports coming in softer than expected. The Fed therefore doesn't seem to be taking much comfort from these prints. There are at least two reasons for this.

First, the softness in the CPI report in part relates to some technical quirks around how the medical services component is computed, which does not give any signal about underlying inflation pressure.

This component is likely to continue to weigh on CPI inflation for much of next year. However, the same effect does not show up in PCE inflation, which the Fed forecasts and targets. This means that CPI is likely to fall faster than PCE in 2023, with the Fed taking more signal from the PCE data. This will be an important consideration for investors watching inflation data next year.

Second, and more fundamentally, labour market data since September has continued to point to significant excess demand, with wage growth running well ahead of a target consistent rate. The Fed will need to see a sustained cooling in the labour market and a significant slowdown in wage growth before it takes comfort in the underlying inflation picture.

Indeed, the rest of the forecasts seemed to represent another important move by the Fed away from the idea of "immaculate disinflation". That is, the Fed's growth and unemployment forecasts increasingly recognise the economic pain necessary to restore price stability.

The 2023 GDP forecast was revised down 0.7ppt to 0.5%, while the 2024 forecast came down by 0.1ppt to 1.6%. The combination of higher inflation forecasts and lower growth forecasts at the same time seems like an implicit downgrading of supply forecasts. Despite this, the unemployment rate is only forecast to rise from 3.7% to 4.6% in 2023 (vs. 4.4% previously) and then stay at 4.6% in 2024 (vs. 4.4% previously).

This is a very small increase in unemployment by historic standards, with the Fed seemingly continuing to have faith in labour market cooling largely occurring through falling vacancies.

Fed still too optimistic about recession risks

We continue to think these forecasts look too optimistic. Our analysis suggests that the degree of financial condition tightening the Fed has already delivered will deliver a much sharper slowdown in growth next year than incorporated by the Fed.

Moreover, there is a growing literature, including our own work on stall speed dynamics, which suggests that the kind of persistently very low growth the Fed is forecasting next year (i.e. 0.5%), is very difficult to maintain without the economy falling into a recession. Put another way, the Sahm rule suggests it is difficult for unemployment to rise by the amount the Fed is forecasting, without it rising much further.

That is why our biggest disagreement with the Fed dots and broader market pricing is with the path of rates from late 2023 onwards. The SEP dots show only a modest cutting cycle by the end of the Fed's forecast horizon, and almost all the dots show rates above the median longer-run dot (of 2.5%) in 2025. So the Fed thinks policy will be net restrictive across the entire forecast horizon.

In our base case, we continue to see rates returning to the effective lower bound, as unemployment rises more significantly than the Fed forecasts. Even if inflation proves to be stickier than we forecast in our base line, and rates need to be restrictive for longer, we foresee a much more significant cutting cycle than market pricing by 2024.

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