Research Institute – Letters from America

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Plotting the path ahead for the Fed

Our baseline forecast sees the Fed holding rates at restrictive levels until September next year, before eventually cutting back to the lower bound. Various monetary policy rules are consistent with this view. But should inflation prove stickier, then rates may only return to neutral, rather than a more pronounced easing cycle.

Key takeaways

- We expect the Fed to hike rates by a further 100 bps, with two further 50bps moves in December 2022 and February 2023. But if US economic activity holds up better than we expect around the turn of the year, there is scope for further upward revisions to the terminal rate.
- Our forecasts then see the Fed keeping rates elevated until September next year even as the recession starts to bite.
- However, once the pace of core inflation has credibly fallen back to a target consistent rate, we see the Fed cutting rates rapidly back to neutral, before cutting to the effective lower bound in 2024.
- To test our policy assumptions, we consulted a variety of monetary policy rules. Across a range of policy rule specifications, the "appropriate" path of policy sees rates return to zero
- However, were core inflation to prove more persistent then a shallower cutting cycle is possible. Indeed, if the recent high inflation environment sees the Fed putting a higher weight on achieving price stability in their policy making, rates may only return to the neutral even with much higher unemployment.

Policy uncertainty is high

We expect the Fed to hike rates by a further 100 bps, with two further 50bps moves in December 2022 and February 2023. This will take the terminal Fed Funds target range to 4.75%-5%.

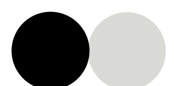
In his press conference following the November FOMC meeting, Chair Powell heavily hinted at the prospect of the next FOMC 'dot plot' of rate projections showing a higher terminal rate than the September vintage. We are inclined to fade the signal from any upward revision to the dots on the basis that we think the economy will be in recession in Q2 next year.

Strength of US activity and slowing inflation will be key

However, if US economic activity holds up better than we expect around the turn of the year, there is scope for further upward revisions to the terminal rate. We would tend to frame any US demand-side resilience less as a reason to down-weight the possibility of a recession, and more a sign that the short run r* is even higher than expected. In which case, interest rates would need to be pushed higher to bring about the necessary degree of economic rebalancing.

Chair Powell also used his press conference to stress the importance of keeping policy restrictive for some time to bring inflation back under control. He argued the Fed could always ease policy if it turned out it was too restrictive. But excessively easy policy would risk de-anchoring inflation expectations, and be much more painful to eventually correct.

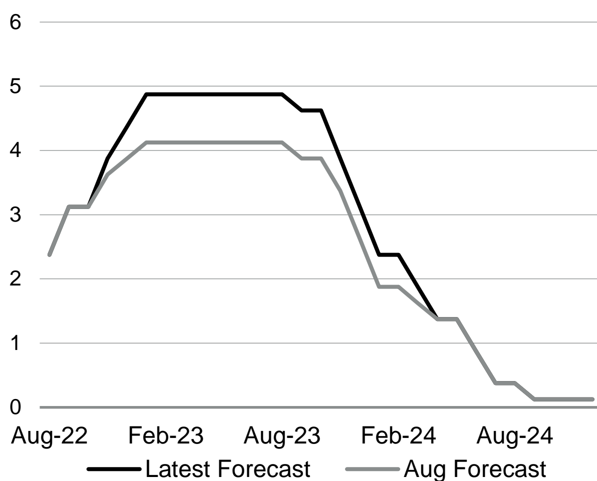
This is a reversal of the standard balance-of-risks argument the Fed deployed for much of the post-financial crisis period, when the idea was that the presence of the lower bound meant that over-tightening was riskier than over-easing.



We read this as consistent with our forecasts, which show rates being kept at the terminal rate until September next year even as the recession starts to bite.

However, once the rate of core inflation has credibly fallen back to a level consistent with the inflation target, we see the Fed cutting rates rapidly back to neutral, before cutting to the effective lower bound in 2024 (see Figure 1).

Figure 1: Updated path for the Fed funds



Source: abrdn as of November 2022

Testing this lower bound assumption

To calibrate the speed and extent of the Fed's easing cycle, we consulted a variety of monetary policy rules. While such rules are far from an infallible guide to policy, and do not consider all the discretionary judgements policy-making involves, they are a good way of systematically gauging the trade-off policy makers face between activity and inflation.

These rules typically take the form below, where the implied policy path is dictated by this trade-off, the equilibrium interest rate, and the extent to which policy setting is smoothed overtime.

Basic Monetary Policy Rule:

$$\hat{r}_t = \rho\hat{r}_{t-1} + (1-\rho)[r_t^* + \pi_t^* + 1.5(\pi_t - \pi_t^*) + \beta gap_t]$$

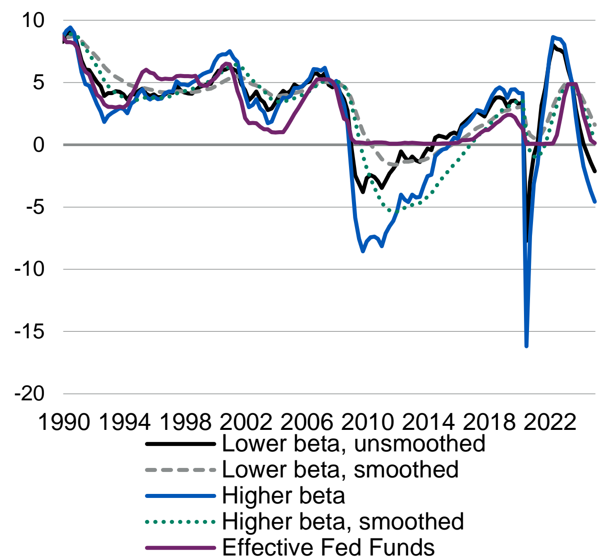
Where: $\hat{r}_t$ is the rule implied Fed funds rate, ρ is a smoothing parameter, r^* is the natural rate of interest, π^* is the target rate of inflation, π is the realised rate of core PCE inflation, gap is the unemployment gap.

To gauge the appropriate path of policy in our base case, we first adjusted the parameters in the rule, keeping our forecasts for inflation and unemployment fixed.

When we change the relative importance of growth versus inflation, by changing beta, the first thing of note is the difference in the extent of the recommended loosening through the Global Financial Crisis (GFC) and pandemic recessions (see Figure 2).

When we put a higher weight on unemployment the implied policy rate is much lower through downturns, leading to greater policy volatility.

Figure 2: Implied policy rates with changes in rule specification



Source: CBO, Atlanta Fed, abrdn as of November 2022

The smoothing of policy setting leads to a slowed pace of cutting in downturns, and hiking in expansions, but also dampens some of the more extreme values implied by the non-smoothed versions.

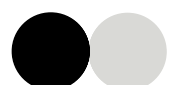
For example, the smoothed versions would imply a gradual return to near-zero as is our base case while the unsmoothed rules would suggest both a faster pace and greater degree of loosening.

In these policy rules, the implied rate turns negative but not to the extent seen in the GFC, that is why we continue to see this easing cycle involving rates returning to zero, but without the use of asset purchases which marked earlier lower bound episodes.

Inflation uncertainty would keep rates higher

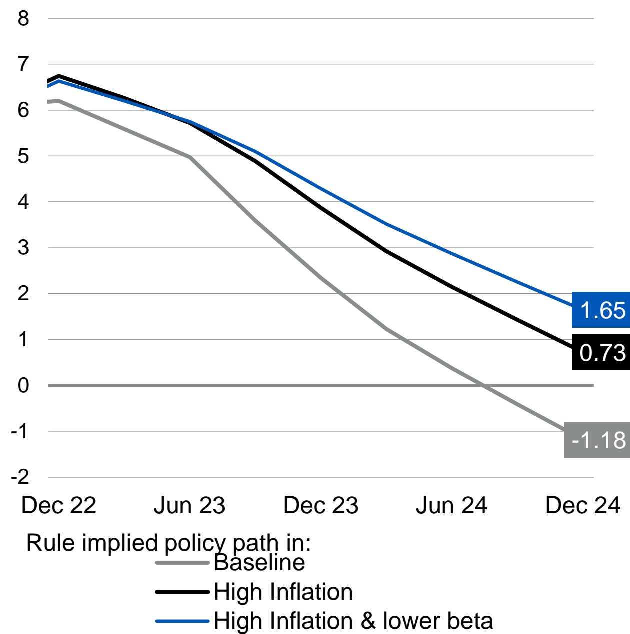
Given the uncertainty around our inflation forecasts, we also formally modelled a scenario in which inflation proves to be stickier into the recession. In this case, the cutting cycle would be more modest with rates only just returning to a neutral setting under some policy rules and the average sitting above the lower bound at 0.73% (see black line in Figure 3).

When we put more weight on inflation than the unemployment gap in the determination of the Fed policymaking - the implied policy rate is even higher sitting just below neutral at 1.65% (see blue line in Figure 3). Given the recent history of high and persistent inflation we do think that the path for inflation is likely to factor more heavily into



the Fed's thinking therefore it is possible that this is an upside risk to our base case view for the Fed.

Figure 3: Inflation persistence would prevent a return to the lower bound



Source: CBO, Atlanta Fed, abrdn as of November 2022

Our latest US forecasts

- **Activity:** Recent US economic data has been mixed. Interest rate sensitive sectors of the economy have been hit hard by the Fed's rapid monetary policy tightening, and are slowing sharply. However, consumer spending has been more resilient, with the labour market still looking robust. On balance, we continue to expect the US economy to enter into a recession in the second quarter of 2023, with risks skewed to a later start.
- **Inflation**: Headline inflation is now well past its peak, but core inflation is likely to be stickier. After several successive months of coming in above expectations, core inflation was a little weaker than expected in October at 6.3%. With employment data still consistent with an overheating labour market, and little sign of a pronounced recovery in the supply side, we remain sceptical that a soft landing is possible.
- **Monetary policy**: We expect the Fed to slow the pace of rate increases to a 50bps increase in December, after delivering four conservative 75bps hikes. We would strongly caution against interpreting this slowing in the pace of hikes as a dovish "pivot". We expect rates to peak with a target range of 4.75-5%. Risks are skewed to the upside, and the next FOMC dots may signal a higher terminal rate, but we think the onset of a recession in Q2 will see the Fed abandon plans for further rate hikes.

	2021	2022	2023	2024
GDP (%)	5.9%	1.9%	-0.6%	-0.2%
CPI (%)	4.7%	8.1%	4.1%	2.5%
Policy Rate (%, year-end)	0.13	4.38	3.13	0.13

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