Fed Watch

Fed to start raising rates more aggressively to tackle 40-year-high inflation and anchor expectations

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We expect the Fed to hike the fed funds rate by 50bps and launch QT amid "much too high" inflation

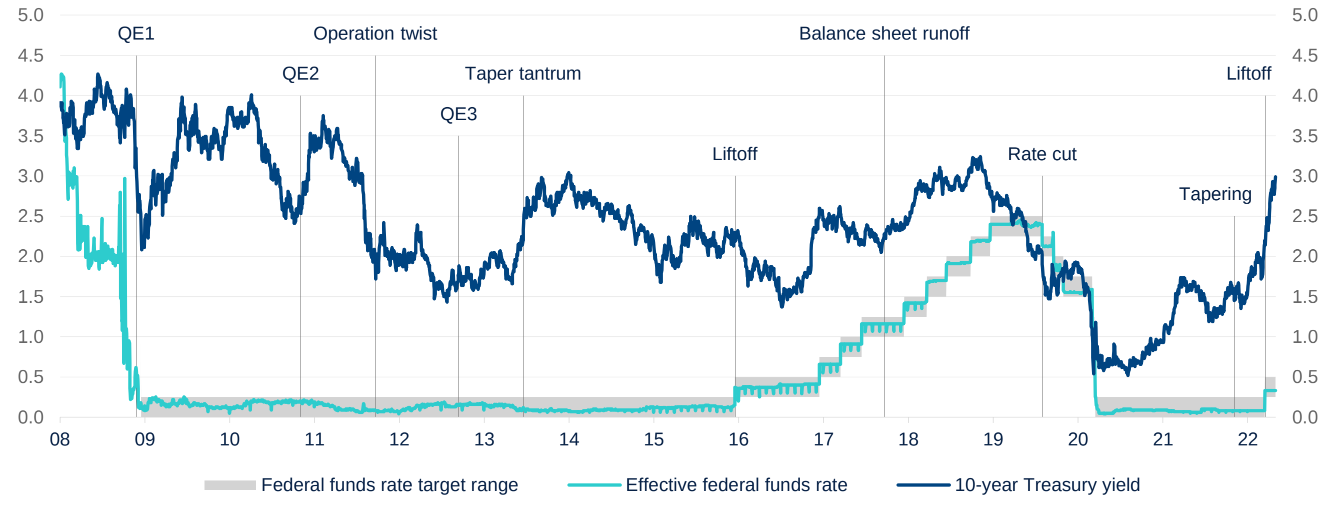
- **Last March, the Fed raised the fed funds rate for the first time since the start of the pandemic.** A widely expected 25bps hike marked the beginning of a process to remove monetary policy accommodation (Figure 1). At its November 2021 meeting, the FOMC announced that it would begin reducing the pace of its asset purchases that month. Then in December, the FOMC agreed to speed up the pace of reduction and end the asset purchases earlier, by mid-March. The monetary policy settings had not changed much at that point, but the FOMC's forward guidance was priced in by financial markets—for example, with 2-year and 5-year Treasury yields increasing about 100bps from early October until the invasion of Ukraine by Russia in late February. This put the Fed in a better position to control inflation over the next few years. Short-term inflation expectations have risen with inflation, but longer-run expectations, as those reflected in the 5-year forward inflation rate implied in Treasury securities, remain well anchored in their historical ranges (Figure 3).

- **With the Fed now completely focused on getting inflation back to the 2% goal, it will begin to raise the fed funds rate more aggressively**, by 50bps in at least the next two meetings, and will launch quantitative tightening (QT) to begin the reduction of its balance sheet holdings. Judging by recent remarks from FOMC voting members in the intermeeting period (Table 1), it seems clear that there is a wide consensus on a strategy to front-load hikes in the policy rate to reach the steady-state neutral level (2.5%) by the end of this year and to follow with "further rate increases" next year. The Fed has strongly signaled that is set on moving rates fast to take it to the long-run level and "then tightening policy if that turns to be appropriate".

- **The aim will be to bring inflation down while achieving a soft-landing of the economy.** That is, getting inflation under control without threatening the economic expansion and job gains. Although the Fed can do little to ease global supply chain problems and the rate hikes will do nothing to slow down other cost-push factors behind the recent inflation surge, it has acknowledged that inflation is stickier than previously thought. In this backdrop, the Fed does not have a choice and will start to hike more aggressively. The first risk the Fed faces is hurting its credibility if rates are not moved rapidly. The FOMC will not take this risk. The second one is that inflation proves even stickier and remains more persistent despite the planned rate hikes. Under this scenario, not our baseline, the Fed might be forced to tighten policy more than currently priced in, taking rates much higher than it now anticipates and risking an economic recession. Given that the 50bps increase is already priced in by financial markets (Figure 2), the focus will be on the wording of the statement, i.e., on any signs that confirm that tomorrow's move is likely the first of a set of at least two. If, as we currently expect, inflation is peaking, the Fed might shift back to a pace of gradual 25bps rate hikes in the summer. We continue to expect 200bps of rate increases through year-end to 2.5% followed by a total of 50bps further increases in 1Q23. As of today, risks are tilted towards more hikes.

With a much more hawkish Fed, the yield curve has priced in several rate hikes and long-term rates have risen substantially, hovering slightly below 3.0% over the past few weeks

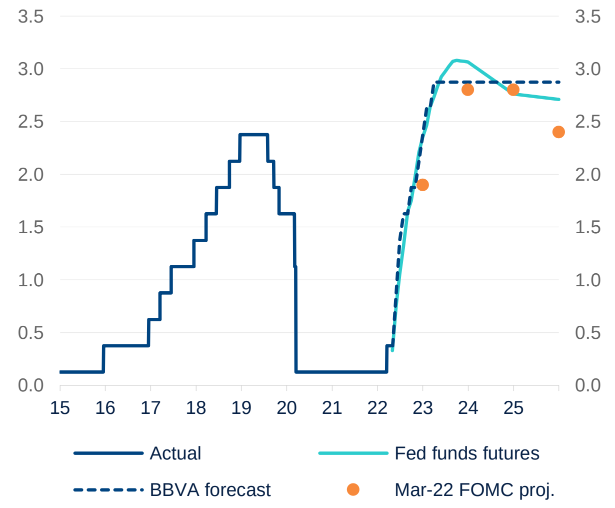
Figure 1. **10-YEAR TREASURY YIELD AND FED FUNDS RATE** (CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

The fed funds rate will likely reach at least 3% by the end of the first quarter of 2023

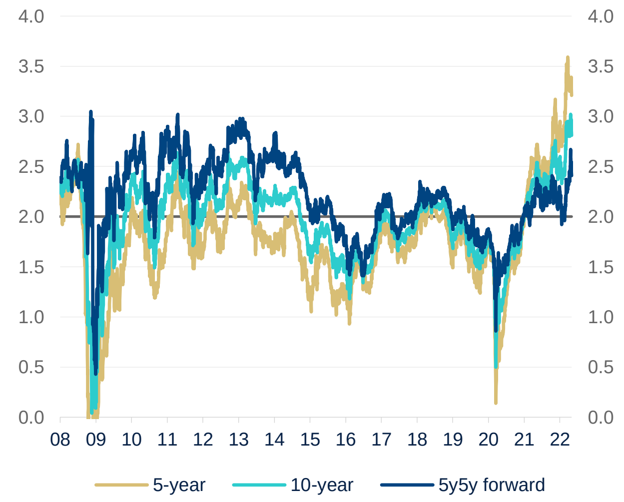
Figure 2. **FEDERAL FUNDS RATE OUTLOOK** (TARGET RANGE MIDPOINT, %)



Monthly quotes for fed funds futures through Dec-23, and Dec quotes for 2024 and 2025.
Source: BBVA Research based on data by the Federal Reserve, Bloomberg, and Haver Analytics.

Longer-run inflation expectations remain relatively low but have risen sharply

Figure 3. **BREAKEVEN INFLATION RATES** (CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

There is a wide consensus among FOMC voting members on a strategy to front-load hikes in the policy rate to reach the steady-state neutral level by year-end followed by further rate increases next year

Table 1. **RELEVANT REMARKS FROM FOMC VOTING MEMBERS**

Relevant remarks on the path of monetary policy
Jerome Powell (Board, Chair). At the 38th NABE conference (see), Powell reaffirmed the need to "expeditiously" move the policy stance to neutral levels amid a strong labor market and "much too high" inflation. From now on, the FOMC will not assume significant supply-side relief in the near term. He pointed that "the risk is rising" that persistent high inflation could push longer-term expectations higher. In this context, he signaled possible 50bps increases for the fed funds rate at upcoming meetings and noted QT to begin as soon as May. Even though the main goal is to get to neutral levels, an eventual movement of the policy stance to restrictive levels is not discarded. Powell's words were little changed during his participation in the IMF seminar on the Global Economy (see), where he added that the Fed will use its tools to achieve a soft landing amid the front-loading strategy to begin this month.
John Williams (New York, Vice Chair). During a speech delivered at the Princeton University (see), Williams referred to inflation as being "too high" and recognized its spread across many categories of goods and services. With longer-run inflation expectations still well anchored, he pointed that the FOMC is focused on "restoring price stability" as inflation is now projected to return close to the 2% target until 2024. In his opinion, QT could begin as soon as May.
Lael Brainard (Board). Brainard offered a speech at an event held by the Federal Reserve Bank of Minneapolis (see), where she referred to inflation to be "much too high" and subject to upside risks related to the extension of supply chain bottlenecks derived from Russia's actions and the COVID lockdowns in China. She highlighted the fact that the Fed's communications "have resulted in broad market expectations for an expeditious increase in the policy rate toward a neutral level", and that stronger action could be warranted in face a deterioration of longer-run inflation expectations. She also noted that QT, starting at a rapid pace as soon as May, "will contribute to monetary policy tightening over and above the expected increases in the policy rate".
Christopher Waller (Board). Two days after the March FOMC decision, Waller commented to the media (see) his favor on front-loading the fed funds rate hikes, "which would imply 50bps at one or multiple meetings in the near future". Waller noted that the geopolitical events pushed him off from advocating for a 50bps hike in the last meeting. On the balance sheet, he pointed that the strength of the US economy allows to "draw down a large amount of liquidity [...] without really doing much damage". During a speech delivered at a conference on housing markets (see), he noted that unlike the housing crash of a decade ago, the recent increase in housing prices "seems to be sustained by the substantive supply and demand issues [...] not by excessive leverage, looser underwriting standards, or financial speculation". More recently, Waller reaffirmed his view of 50bps hikes at upcoming meetings, noting the need to get closer to neutral "as soon as possible" and above neutral by the end of the year.
Loretta Mester (Cleveland, 2022 voter). Mester offered a speech on her views on the economy and monetary policy at the John Carroll University (see), where she supported the opinion that allowing high inflation to persist in the expectation of supply-side relief is "too risky". With inflation expectations still at levels consistent with the longer-run goal of 2% inflation, she finds it appealing to front-load some of the needed increases to move the fed funds rate this year to her longer-run estimate of 2.5%, and to follow with further increases next year. In his opinion, "if inflation is moving down faster than expected, [the FOMC] could slow the pace of rate increases in the second half of the year". She also highlighted that QT would remove the downward pressure that the Fed holdings put on yields at the long end of the yield curve, "reducing monetary policy's distortionary effects on the shape of the yield curve as normalization proceeds". Similar remarks were provided later to the media (see) and during a speech delivered more recently at the University of Akron (see).
James Bullard (St. Louis, 2022 voter). Trough an official statement, Bullard first explained his dissent with the March FOMC decision (see), arguing that a 50bps adjustment would have been a better decision in a context where "monetary policy has been unwittingly easing further". In his view, the FOMC will have to move quickly or risk losing credibility. He recommended trying to achieve a 3% fed funds rate by the end of this year. Later in an interview (see) he highlighted this need at least so that the current policy stance does not put more upward pressure on inflation. Bullard's estimate for the neutral fed funds rate is 2%. In a later note (see), Bullard argued that the FOMC's forward guidance is already reflected in market pricing, in a context of a fed funds rate still near peak accommodation and a nearly $9 trillion balance sheet, which he believes should be quickly reduced. More recently, at both the University of Missouri-Columbia (see) and the Princeton University (see), Bullard provided two interpretations on the belief that the Fed is behind the curve. In his opinion, the Fed is far behind the curve on the definition of standard Taylor-type monetary policy rules, but not as far behind considering that forward guidance has substantially increased interest rates in advance of tangible Fed action.
Esther George (Kansas City, 2022 voter). During her participation in the Economic Club of New York (see), George delivered a speech about her view on the path of price stability, in which she noted that inflation at a 40-year high has "broadened its reach", calling for an expeditious movement to a neutral stance, adding that if inflation remains elevated, more restrictive policy may be required to reinforce an anchoring of inflation expectations. On the balance sheet, she noted that its run-off is likely to put upward pressure on longer-run interest rates, possibly steepening the yield curve.
Patrick Harker (Philadelphia, 2022 alternate voter for Boston and 2023 voter). In the intermeeting period, Harker offered three similar speeches at the Center for Financial Stability (see), the Delaware State Chamber of Commerce (see), and the Rider University (see). Being "acutely concerned" about high and widespread inflation, Harker recognized that fiscal policies, supply chain disruptions and an accommodative monetary policy have all pushed inflation far higher than he and the FOMC are comfortable with. In this context, he also shared his concern on the risk of inflation expectations becoming "unmoored". Parker expects a series of deliberate, methodical hikes for the rest of the year, while also anticipating that the reduction of the balance sheet will begin soon.

Source: BBVA Research.

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