Fed Watch

Fed steps up tightening pace and pivots to a more aggressive approach

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June 15, 2022

Main goal is to avoid long-run inflation expectations de-anchoring; rates will be at a "modestly restrictive level" by year-end

- **The Fed raised the policy rate by 75 bps to a target range between 1.5 and 1.75% and signaled that another hike of this size was possible at its next meeting[1], but also that multiple consecutive 75 bps hikes were unlikely[2].** The (not unanimous) decision[3] was widely expected (us included, see) after a WSJ note hinted that the Fed was going to deliver a larger hike today, sharply reshaping short- and mid-term policy expectations. Chair Powell acknowledged in the Q&A that the Fed decided to move rates more aggressively following the unexpected large negative inflation surprise in May and the worrying rise in the University of Michigan inflation expectations figures, both released during the blackout period. Powell said that the Fed had been "expecting progress" on a flattening out of inflation but "didn't get that, [they] got the opposite".
- **The few tweaks to the wording of the policy statement along with chair Powell remarks point to the second pivot in Fed's approach to this hiking cycle.** The first pivot came in late 2021 when the Fed signaled that it was planning on a series of gradual rate hikes to take the policy rate to at least a neutral level. The second pivot came today, as FOMC officials "came to the view that [they] wanted to do more front-loading" of rate increases. Chair Powell added that they would like to see slightly restrictive monetary policy, taking the target range between 3% and 3.5% by the end of the year and that additional hikes next year (probably to 4%) might be the appropriate path for the target rate to bring inflation down. Powell wanted to continue reshaping expectations for the target rate to a range broadly consistent with markets' expectations (since yesterday) by saying that "policy will have to be restrictive", adding that FOMC officials don't know yet how restrictive it would be.
- **The two main changes in the statement show that the Fed is determined to slow demand until imbalances decrease.** First, the statement dropped the reference to the uncertain implications for the US economy of the invasion of Ukraine by Russia, and now fully acknowledges that it is weighing on economic activity and exerting upward pressure on inflation. Second, the phrase about the FOMC's expectation that even with policy firming the labor market was going to remain strong was dropped. Powell addressed these issues in the Q&A, signaling that they will do their job even if "so much is beyond the scope of monetary policy". Although he acknowledged that there are many factors that the Fed doesn't control and could ultimately determine "whether a [softish landing] is possible or not", he also said that it was possible and "there was a path to get there". The path is to "move demand down" because "there is a lot of surplus demand". When asked whether he thought a higher unemployment rate (UR) was necessary to bring about the needed demand slowdown, he answered that the current rate (3.6%) was too low and that the (new) expectation of a 4.1% rate

[1] Chair Powell said in the Q&A that the next meeting "could be a decision between 50 bps and 75 bps".
[2] Chair Powell also said that he does not expect moves "of this size to be common".
[3] Kansas City Fed President Esther George dissented, she favored a 0.50% move.

"would be a successful outcome". Powell acknowledged that slowing demand to bring inflation down without causing significant pain was "not getting any easier", but that the most costly mistake the Fed could make "would be to fail, which is not an option" and "hence [their] resolution to get rates up".

- **Through the updated Summary of Economic Projections (SEP) and the accompanying dot plot, the Fed signaled a much steeper path of rate hikes and a wider consensus among FOMC participants on the need to take the fed funds rate to a restrictive level.** A marked slowdown in expected real GDP growth (to 1.7% in both 2022 and 2023, down from 2.8 and 2.2%, respectively) and upward revisions to the expected path for the UR (to 4.1% in 2024, up from 3.6%) reflect the Fed's more aggressive approach to bringing about the demand slowdown needed to restore price stability (Table 1). As argued before, Powell explained that "the role [the Fed] can play is around demand, excess demand". Both the Fed's pivot and changes in the SEP are consistent with Fed's resolve to tame inflation. Last March, only one FOMC participant (out of sixteen) had assessed that the appropriate stance of monetary policy would most likely require raising the fed funds rate above 3% by the end of this year. Just three months later, the story is quite different. This month's SEP shows that all participants now expect that the fed funds rate would need to reach a level above 3% by year-end. The median participant expects a 3.8% terminal rate in 2023 before falling back to 3.4% a year later. The dot plot (Figure 1) also let us conclude, as we anticipated yesterday (see), that there is now a much wider consensus among meeting participants with regards to the need to expeditiously place the policy rate above the steady-state neutral rate[4], as the central tendency range for the fed funds rate lies now between 3.1% and 3.6% by the end of this year, compared to a 1.6%-2.4% central tendency range three months ago.
- **The Fed will most likely take the rate above 3.0% and 3.5% by year-end and 1H23, respectively.** This is a significant change in plans, but consistent with the view we have held over the last few months that the Fed would take the policy rate beyond the 3% level. Even if the Fed wants to continue to "provide as much clarity as [it] can'', the only certainty seems to be that the next hike will be between 50 and 75 bps and that it is very unlikely that the Fed will take a breather anytime soon. For the Fed to shift back to smaller hikes, there needs to be some progress on inflation. Given that inflation is unlikely to flatten out by the time of the next meeting (July 26-27) we think that a second consecutive 75 bps is now likely. Looking ahead, once inflation flattens out, the Fed might shift back to a 50 bps hike in September, followed by two 25 bps hikes in November and December, once inflation starts to show clear signs that it is coming down. Such a path would bring the target range of the fed funds rate to 3.25%-3.5% by year-end. One or two additional hikes in early 2023 seem likely but will depend on the inflation path. Although the Fed finds some comfort in the fact that high inflation is not "affecting long-run inflation expectations" and that the economy is not "seeing any signs of a wage spiral", chair Powell highlighted that it is key to "sustain that confidence". Today's pivot to a more aggressive approach could make that job easier. Market expectations have already sharply adjusted, financial conditions are already tighter. The Fed is determined to keep the continued confidence that long-term inflation expectations are showing that it will be able to bring inflation down to its 2% target, even in the presence of the many factors beyond its control. As Powell said in the press conference, the Fed is "absolutely determined to keep [long-run inflation expectations] anchored". Lastly, the odds that the Fed will achieve a soft landing could become slimmer if the Fed needs to tighten more to soften demand enough to bring down inflation. Chair Powell acknowledged that financial conditions have tightened but consumption remains strong. The Fed needs to see a larger effect of this tightening on demand to get the job done. The Fed wants to soften demand with higher rates until there is a better balance with supply in both the goods and labor markets. This, along with convincing signals that inflation is decisively easing, are the signs the Fed will be looking for the hiking cycle to end. For now, it still has legs.

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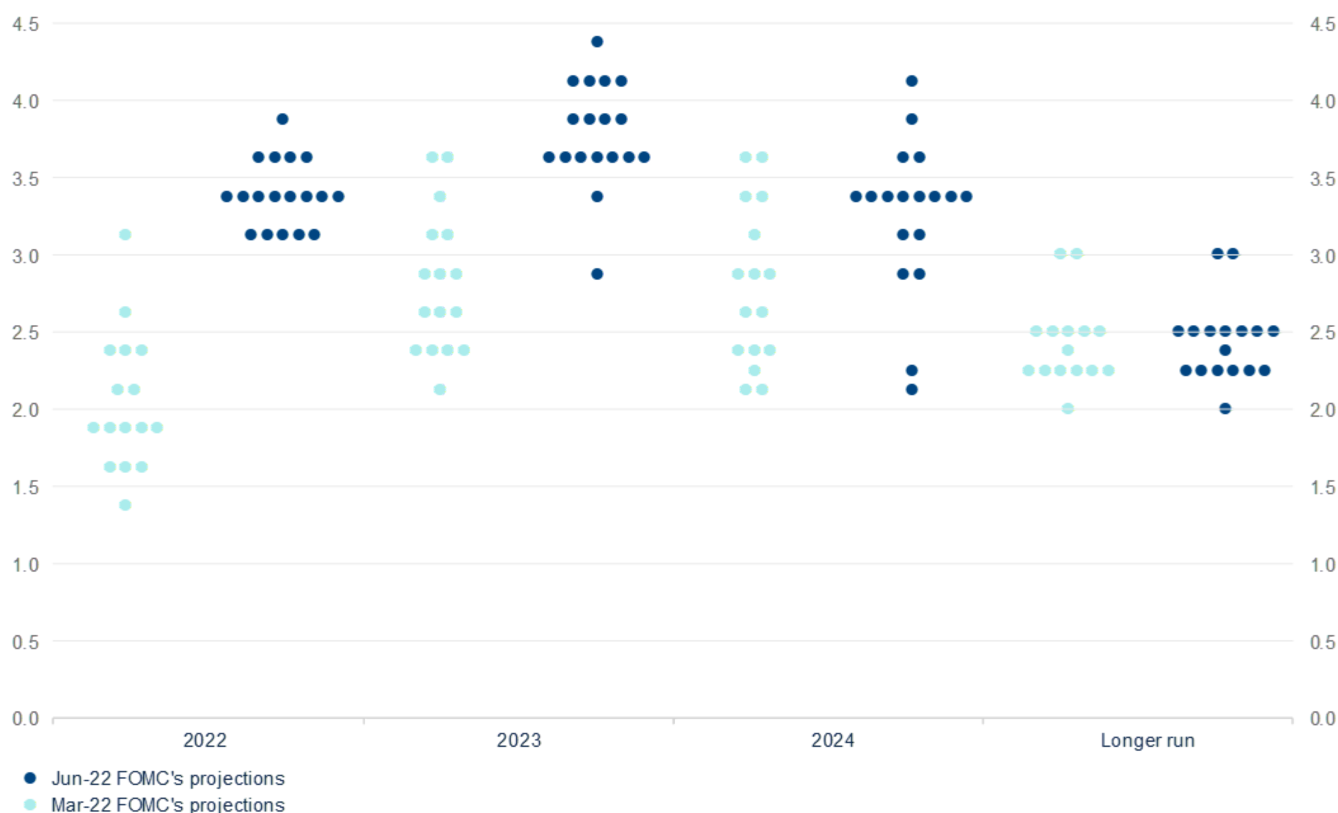
[4] Estimated by the participants themselves to be in a range between 2 and 3%.

Through the updated SEP and the accompanying dot plot, the Fed signaled a much steeper path of rate hikes and a wider consensus on the need to take the fed funds rate to a restrictive level

Table 1. **FOMC PARTICIPANTS' SUMMARY OF ECONOMIC PROJECTIONS** (JUNE 2022, %)

Variable	Median				Central tendency				Range			
	2022	2023	2024	LR	2022	2023	2024	LR	2022	2023	2024	LR
Change in real GDP	1.7	1.7	1.9	1.8	1.5-1.9	1.3-2.0	1.5-2.0	1.8-2.0	1.0-2.0	0.8-2.5	1.0-2.2	1.6-2.2
Mar-22	2.8	2.2	2.0	1.8	2.5-3.0	2.1-2.5	1.8-2.0	1.8-2.0	2.1-3.3	2.0-2.9	1.5-2.5	1.6-2.2
Unemployment rate	3.7	3.9	4.1	4.0	3.6-3.8	3.8-4.1	3.9-4.1	3.5-4.2	3.2-4.0	3.2-4.5	3.2-4.3	3.5-4.3
Mar-22	3.5	3.5	3.6	4.0	3.4-3.6	3.3-3.6	3.2-3.7	3.5-4.2	3.1-4.0	3.1-4.0	3.1-4.0	3.5-4.3
PCE inflation	5.2	2.6	2.2	2.0	5.0-5.3	2.4-3.0	2.0-2.5	2.0	4.8-6.2	2.3-4.0	2.0-3.0	2.0
Mar-22	4.3	2.7	2.3	2.0	4.1-4.7	2.3-3.0	2.1-2.4	2.0	3.7-5.5	2.2-3.5	2.0-3.0	2.0
Core PCE inflation	4.3	2.7	2.3		4.2-4.5	2.5-3.2	2.1-2.5		4.1-5.0	2.5-3.5	2.0-2.8	
Mar-22	4.1	2.6	2.3		3.9-4.4	2.4-3.0	2.1-2.4		3.6-4.5	2.1-3.5	2.0-3.0	
Federal funds rate	3.4	3.8	3.4	2.5	3.1-3.6	3.6-4.1	2.9-3.6	2.3-2.5	3.1-3.9	2.9-4.4	2.1-4.1	2.0-3.0
Mar-22	1.9	2.8	2.8	2.4	1.6-2.4	2.4-3.1	2.4-3.4	2.3-2.5	1.4-3.1	2.1-3.6	2.1-3.6	2.0-3.0

Figure 1. **FOMC PARTICIPANTS' PROJECTED APPROPRIATE FEDERAL FUNDS RATE** (%)



Source: BBVA Research based on data by the Federal Reserve and Haver Analytics.

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