Fed Watch

Hawkish 75bp fed funds rate hike signals a higher peak for rates…

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… while the updated "dot plot" reinforces the Fed's "higher rates for longer" approach to bring inflation down to 2%

- **The Fed delivered the third consecutive 75bp hike, taking rates to 3.0-3.25% as widely expected following the stronger-than-expected August core CPI print.** The decision was unanimous. The wording of the statement was mostly unchanged -the Fed now described activity indicators as pointing to modest growth. We were expecting today's overall tone in the press conference and the update of the Summary of Economic Projections (SEP) to back up Fed's hawkishness since Jackson Hole (see). Both chair Powell and the new projections were more hawkish than anticipated, and thus went beyond just that. Chair Powell kept a hawkish tone throughout the press conference and the Q&A. He said that as the stance of policy tightens further, it will be appropriate to slow down the pace of increases, thus signaling that **another 75bp hike** was **more likely than not in November** and that rates will likely go higher than previously thought.

- **FOMC participants reinforced their hawkish tone from recent weeks through the updated Summary of Economic Projections (SEP) and the accompanying "dot plot".** The median projection for real GDP growth for this year was strongly revised to the downside to 0.2% (from 1.7% in June), while next year's growth rate is still expected to remain positive at 1.2% (down from 1.7% in June) before ticking up to 1.7 and 1.8% by the end of 2024 and 2025, respectively. Consequently, the median FOMC participant now anticipates a higher unemployment rate of 4.4% by the end of both 2023 and 2024 (up from 3.9 and 4.1%, respectively). These projections for economic activity appear to be still consistent with an increasingly unlikely scenario in which the Fed achieves a soft-landing, i.e., a sustained period of below-trend growth coupled with some softening of labor market conditions (Table 1). Chair Powell acknowledged the increasingly challenging context for economic activity as the Fed continues to raise rates: "no one knows whether this process will lead to a recession". Continued relative optimism on activity and the labor market (as demand for workers still substantially exceeds the supply of available workers) contrasts with the main message sent today: rates still need to go sharply up "to put meaningful downward pressure on inflation". That is, the Fed now thinks that monetary policy will need to be more restrictive to bring inflation under control.

- **The updated "dot plot" reinforces Fed's most recent pivot: rates need to increase more than previously thought and need to stay higher for longer to bring inflation back down to 2.0% (Figure 1).** Just last June, the median participant anticipated that the moderately restrictive level that the fed funds rate would reach sometime in 2023 would not exceed 4%. Today, the story is quite different: the fed funds rate is now expected to reach 4.4% by the end of this year, and increase a little more to 4.6% by the end of next year. The Fed still expects an easing cycle to start in 2024, and although the range of projections is much wider for that year, for now most FOMC members anticipate that rates will still stay at a restrictive level of 3.9% by the end of 2024. The updated fed funds projections will likely shift to the upside expectations of future hikes as they did not only backed up recent hawkishness but sent a clear signal that the most likely scenario is that by January rates will increase beyond what was priced into futures markets before the meeting. As Chair Powell noted in his press conference opening statement, the Fed will keep “moving [the] policy stance purposefully to a level that will be sufficiently restrictive to return inflation to 2%.

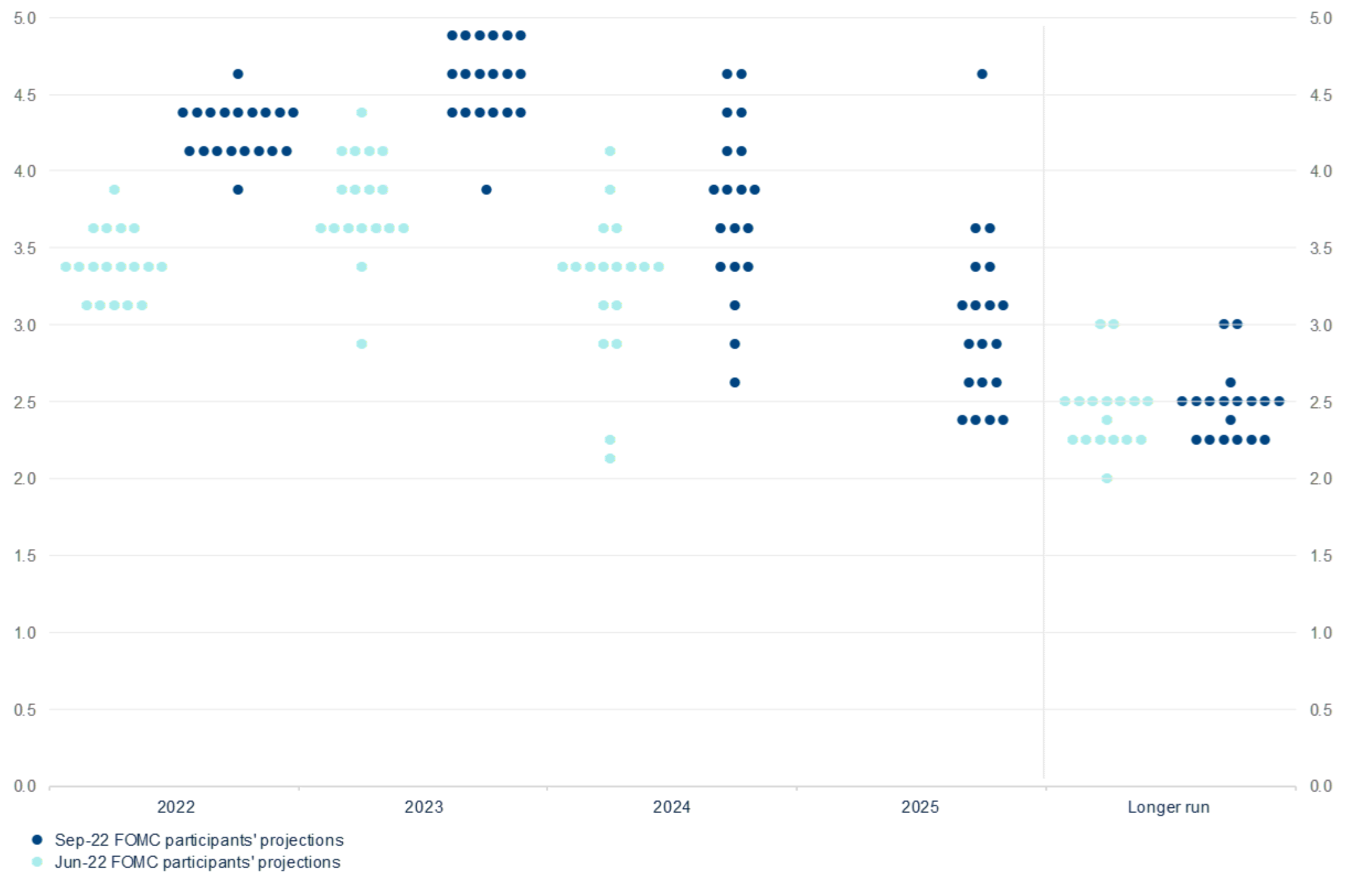
- **We now expect the Fed to continue to front load rate hikes and add 125bp worth of additional tightening by December, lifting the target range to 4.25%-4.50%**, with hikes of 75bp and 50bp in November and December, respectively. Chair Powell said that to slow rate hikes the Fed would need to see “clear evidence” that inflation is slowing. He also signaled that rate cuts might start before inflation falls down to target -as also suggested by the “dot plot”-, as long as the Fed feels “very confident” that inflation is moving down to 2.0%. Thus, rate cuts are still likely in 2024 and could even come earlier, in late 2023, if core inflation falls faster than currently anticipated. As of now, we anticipate that the Fed will keep rates unchanged at 4.75% through most of 2023 following a 25bp hike in January.

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 level that is "restrictive enough"

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

Variable	Median					Central tendency					Range				
	2022	2023	2024	2025	LR	2022	2023	2024	2025	LR	2022	2023	2024	2025	LR
Change in real GDP	0.2	1.2	1.7	1.8	1.8	0.1-0.3	0.5-1.5	1.4-2.0	1.6-2.0	1.7-2.0	0.0-0.5	-0.3-1.9	1.0-2.6	1.4-2.4	1.6-2.2
Jun-22	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
Unemployment rate	3.8	4.4	4.4	4.3	4.0	3.8-3.9	4.1-4.5	4.0-4.6	4.0-4.5	3.8-4.3	3.7-4.0	3.7-5.0	3.7-4.7	3.7-4.6	3.5-4.5
Jun-22	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
PCE inflation	5.4	2.8	2.3	2.0	2.0	5.3-5.7	2.6-3.5	2.1-2.6	2.0-2.2	2.0	5.0-6.2	2.4-4.1	2.0-3.0	2.0-2.5	2.0
Jun-22	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
Core PCE inflation	4.5	3.1	2.3	2.1		4.4-4.6	3.0-3.4	2.2-2.5	2.0-2.2		4.3-4.8	2.8-3.5	2.0-2.8	2.0-2.5	
Jun-22	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		
Federal funds rate	4.4	4.6	3.9	2.9	2.5	4.1-4.4	4.4-4.9	3.4-4.4	2.4-3.4	2.3-2.5	3.9-4.6	3.9-4.9	2.6-4.6	2.4-4.6	2.3-3.0
Jun-22	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

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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