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Fed Watch

Fed will deliver a third 75bp hike and back up hawkishness with updated projections

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September 20, 2022

The SEP will point to less confidence in the soft-landing outcome and a challenging road to bring back inflation to below 3.0% levels

- **The Fed "must keep at it until the job is done": Powell's keynote speech at Jackson Hole (see) was his most hawkish message to date and buried expectations that the Fed might start to cut rates early in 2023 if the economy fell into a recession.** Powell laid the groundwork for market expectations to adjust to a scenario of a "sustained period" of lower economic growth to successfully reduce inflation: interest rates will need to reach and stay at levels that restrain growth "for some time". He anticipated "some pain" for households and businesses, and reiterated that "a failure to restore price stability would mean far greater pain". Not only does the Fed convey a clear message that the hiking cycle has legs, but also adjusted expectations for 2023 (Figures 1 and 2) warning that "the historical record cautions strongly against prematurely loosening policy", and reiterated the risks of inflation becoming entrenched if inflation remains too high for too long, even if long-term inflation expectations still appear to remain well anchored (Figure 3).

- **Persistent core inflation coupled with a resilient economy give the Fed "flexibility to be aggressive" against inflation. The Fed will deliver the third super-sized rate hike (75 bps) and might signal that a fourth one might still be in the cards for November.** Even before the negative core inflation surprise of the latest CPI release (Figure 4), Fed members' tough talk on inflation signaled that most members were already leaning towards "another significant increase" in rates (Table 1). Core inflation outsized monthly increase cemented the odds of such a move as markets started to even assign a 10%+ probability of an ever larger (100bp) hike. Fed funds futures now show that markets are now expecting a peak rate of 4.5% (up from c. 4.0% before the negative inflation surprise). The 75bp hike will lift the fed funds target range to 3.0%-3.25%.

- **The Summary of Economic Projections (SEP) update will point to more hawkishness, less confidence on the odds of a soft landing, and continued confidence that inflation will likely return to target in 2024 but will also likely stay at uncomfortably high levels throughout 2023.** To back up hawkishness and avoid an unwanted easing of financial conditions, the 2023 year-end projection for the fed funds rate will probably be slightly above this year's, which would signal that: i) another small (25bp) hike in early 2023 is probable, and that ii) the Fed is planning on keeping rates steady for a long period of time once is done tightening policy to allow inflation to ease towards the 2.0% target. In June, the SEP anticipated the fed funds rate would reach 3.4, 3.8 and 3.4% by the end of 2022, 2023 and 2024, respectively. All three projections will be revised to the upside, likely to c. 4.0, 4.3, and 3.8%, respectively. The new set of projections will also update growth, unemployment rate (UR) and inflation forecasts. New estimates will likely anticipate the UR to top 4.0% next year (up from 3.9% in June projections) and to further increase in 2024. A sizable downward revision to the 2023 GDP growth projection (1.7% in June) is likely. Lastly, 2022 and 2023 PCE inflation (5.2 and 2.6% in June) and core PCE inflation estimates (4.3 and 2.7%) will be revised to the upside to reflect that bringing back inflation to below 3.0% levels will likely be more challenging than previously thought.

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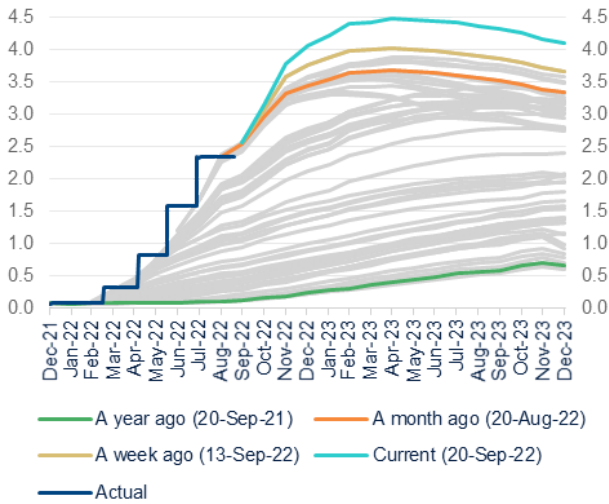
Powell's keynote speech at Jackson Hole adjusted expectations for 2023 warning that…

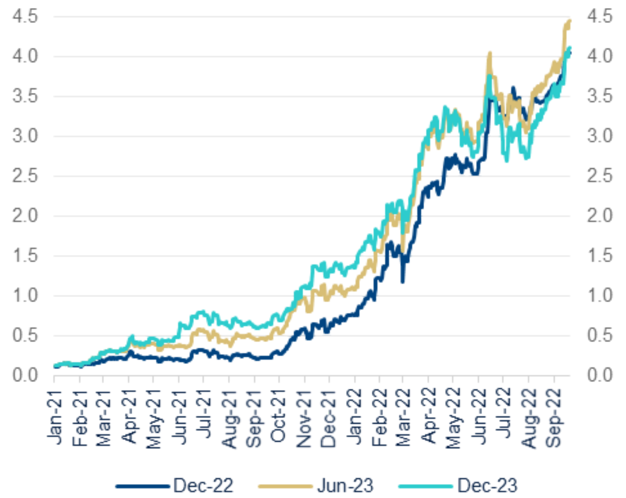
Figure 1. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (DAILY DATA, %)



The gray lines indicate weekly implied rate paths from a year ago.
Source: BBVA Research based on data by Bloomberg.

… "the historical record cautions strongly against prematurely loosening policy"

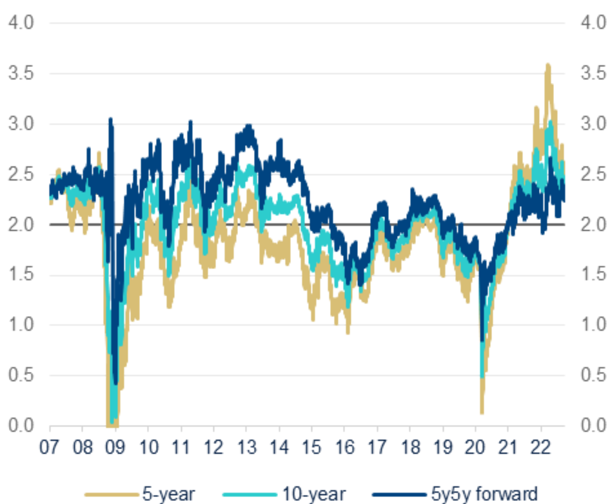
Figure 2. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (DAILY DATA, %)



Source: BBVA Research based on data by Bloomberg.

Market-based longer-term inflation expectations have come back further from their peaks

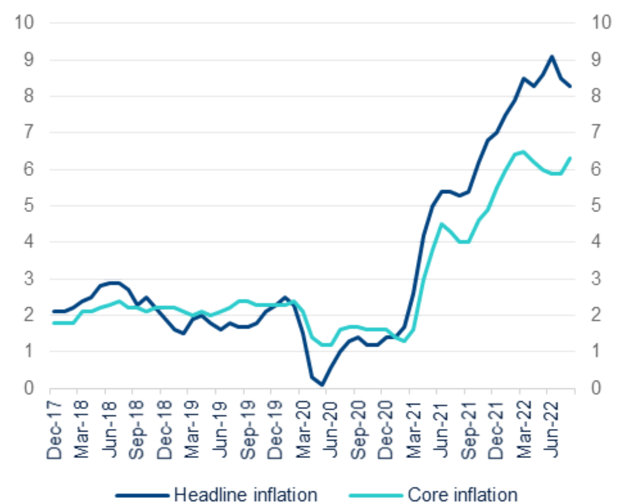
Figure 3. **BREAKEVEN INFLATION RATES** (CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

Core inflation outsized monthly increase cemented the odds of a 75bp hike

Figure 4. **CPI INFLATION RATE** (YoY CHANGE, %)



Source: BBVA Research based on data by Haver Analytics.

The tone on inflation from several FOMC participants grew harsher amid several weeks of easing financial conditions and growing misjudged expectations that the Fed would pivot as soon as early 2023

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

Relevant remarks on the path of monetary policy
Jerome Powell (Board). Powell offered a speech at the Jackson Hole conference (see), where he stressed that reducing inflation will take some time and will likely require a sustained period of below-trend growth and a softening of labor market conditions. He noted that these “unfortunate costs” of reducing inflation will bring some pain, but reiterated that a failure to restore price stability would mean far greater pain. He pointed out that the Fed will purposefully move to a “sufficiently restrictive” level before it becomes appropriate to slow the pace of increases, as the historical record cautions strongly against prematurely loosening policy. He noted the Fed “will keep at it until the job is done”. This hawkish speech came after several weeks of easing financial conditions and a misjudged expectation that the Fed would cut rates early in 2023.
Michelle Bowman (Board). Bowman offered a speech at a summit sponsored by the Kansas Bankers Association (see), where she noted she supports similarly-sized (75bp) increases to the fed funds rate until inflation declines in a consistent, meaningful, and lasting way. She expects that the labor market will remain strong as the Fed continues to increase interest rates and allow the balance sheet to run off, but pointed out that there is a risk that these actions will slow job gains, or even reduce employment. She stressed that the larger threat to the strong labor market is excessive inflation, which if allowed to continue could lead to a further economic softening, risking a prolonged period of economic weakness coupled with high inflation.
Christopher Waller (Board). Waller offered a speech at the Vienna Macroeconomics Workshop (see). He said that inflation is “far too high” and that it is too soon to say that it has peaked, or to see it declining on a sustainable downward trajectory. He noted that the fears of a recession have faded away, and that the strength of the labor market gives the Fed the flexibility to be more aggressive. He said he will support a “significant increase” at the September meeting to move the policy rate into restrictive territory, which in his view needs to reach a level near 4%. Even when the path of tightening is uncertain, he pointed out that further increases will be appropriate until there is “convincing evidence” that inflation is moving “meaningfully and persistently” down.
James Bullard (St. Louis). Bullard reviewed selected post-Volcker literature on credible versus incredible disinflations, at New York University (see). He argued that due to the credibility of today’s central banks, it may be possible for the Fed to disinflate in an orderly manner and achieve a relatively soft landing. He commented to the media (see, see) that the Fed needs to move “aggressively” to bring the policy rate to around 3.75-4.0% by the end of 2022. He also noted that markets were mispricing expectations for future rate hikes and said that the Fed must be prepared to set a terminal rate “a bit higher” than they expected a few months ago, and hold it “higher for longer”. During an interview with the Wall Street Journal (see), he commented he will likely vote for a 75bp hike in the September meeting. At the Jackson Hole annual symposium (see, see), Bullard reiterated his view on reaching 3.75-4.0% by the end of the year, and advocated getting there “as soon as possible”. He also spoke with the Peoria Magazine (see), where he said that the Fed is moving quickly to address inflation, raising rates at a pace only seen in the Greenspan and Volcker era, and pointed out that the balance sheet runoff will also play its role in order to bring inflation under control.
Loretta Mester (Cleveland). Mester commented to the media (see, see) that inflation has not peaked, so monetary policy has to be more restrictive than markets expect. At the Jackson Hole symposium (see, see) she said that the message delivered by Chair Powell was “strong” and “right”. She advocated getting the fed funds rate “somewhat above” 4.0% early next year, and stressed that if the Fed wants to moderate demand, that’s going to involve “some pain”, which means GDP will likely grow below 2% for a while and the unemployment rate will likely rise to a 4.0-4.25% level in 2023. At the Dayton Area Chamber of Commerce (see), she made some remarks on how monetary policy will foster a return to price stability. She noted the need for inflation expectations to remain well anchored, otherwise, high inflation could become embedded. Although she has not incorporated a recession into her baseline scenario, she acknowledged that the outlook is less favorable and that she expects a “fairly sharp slowing in activity”. Finally, she made it very clear that it is less costly to fight and beat inflation now than to fail to do so later (see).
Esther George (Kansas City). At the Kansas Bankers Association Annual Conference (see), George gave some remarks on the role of the banking industry in the US economy. She hosted her last Jackson Hole annual symposium as president of the Kansas City Fed, where she spoke to various media (see, see, see, see). She pointed out that there is “more room to go” for the hiking cycle and advocated for setting the policy rate closer to 4.0% in order to put downward pressure on inflation and move it back down closer to target. She stressed that the important matter is to communicate clearly that the path of monetary policy is toward restrictive territory, and once the Fed reaches the terminal rate, it will stay there for some time. George also commented on the balance sheet runoff, and recalled that it will have some impact in tightening financial conditions. She said that if the Fed wants to get back to a portfolio composed mostly of Treasuries, it will be necessary to sell assets. (i.e., MBS). To conclude, during a virtual event at the Peterson Institute for International Economics (see), she said that with the policy rate still relatively low, the balance sheet still near $9 trillion, and imbalances pushing prices upward, the path for the monetary policy is still "clear-cut": going into restrictive territory.

Source: BBVA Research.

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