Fed Watch

Fed signals once again a higher peak for rates…

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… but lays the ground for a slower pace of hikes as soon as the Dec or Feb meeting; talk about pausing is "very premature"

- As widely expected by analysts (us among them) and market participants, **the Fed delivered the fourth consecutive 75bp hike, taking the fed funds rate to 3.25-4.00%.** The changes to the wording of the policy statement seem to hint smaller hikes ahead but taken together with Chair Powell's remarks, focused on emphasizing that **the main question going forward is related to determining how high will the fed funds rate need to go** "in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time," and not anymore on how fast the Fed should take rates to that level after hiking rates 375 bps so far. It seems that after the aggressive tightening pace the Fed is starting to feel more comfortable with the path of the monetary policy stance and thus acknowledged in the statement that "in determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."

- **Speed is becoming less important now, but the ultimate rate level will be higher than previously projected by the FOMC, expected by most analysts and priced in by financial markets.** Given that the Fed seemed to signal a 4.50-4.75% peak projecting a 4.6% midpoint for the fed funds rate target range at the end of 2023, Powell's remarks signaled that a majority of FOMC members are now projecting a (higher) peak target range of 4.75-5.00%, in line with our recently revised baseline scenario which anticipates a 5.00% peak fed funds rate that will be reached in 1Q23. Powell opened the door for a smaller pace of hikes to come as soon as in Dec but at the same time left the door wide open for another jumbo-sized 75bp hike. As we anticipated, the signals of a possible smaller hike in Dec were not that clear (see) even if the Fed laid the ground for smaller hikes soon. In fact, futures markets following yesterday's FOMC decision think that **the size of the upcoming Dec hike is a coin toss**: 52% odds of a 50bp hike and 48% odds of a fifth 75bp hike in a row. **Powell downplayed the importance of the size of upcoming hikes, instead focusing on the importance of taking rates to a (now) higher peak** in order to bring down inflation. He was careful to avoid sending a message that a possible slower pace of hikes meant that the Fed was on the brink of pausing: in Powell's words, **"it is very premature to be thinking about pausing"**, but the time for slowing the pace of increases is coming, "and it may come as soon as the next meeting or the one after that [though] no decision has been made [and] it is likely [the FOMC] will have a discussion about this at the next meeting." His message was unequivocal: **"[The Fed] still has some ways to go" to meet the test of bringing down inflation "[the Fed] has some ground to cover [...], and cover it we will."**

- **Once the Fed reaches a sufficiently restrictive rate level, which we think will be a 4.75-5.00% target range, uncertainty will revolve around the next phase of the tightening program, which will involve determining for how long to keep a restrictive stance of policy.** The Fed was focused on rapidly taking monetary policy to a more appropriate stance, the next phase will involve slowing the pace of tightening as we discussed above, and the following will be how long should the (eventual) pause last. For now, that is still in the

distant future as risks and uncertainties about inflation remain. That is why Chair Powell stressed that if they end up overtightening, they have the tools to respond. As we argued in the note previewing the FOMC meeting, the next two phases, a downshift in the tightening pace and a pause, will likely be driven by labor market data given that underlying inflation is pointing to short-term stickiness and inflation is set to remain at uncomfortably high levels during these next two phases (see). Powell pointed out that the broader picture is of an overheated labor market where demand substantially exceeds supply. At this point of tightening, the Fed is still looking for obvious signs of the beginning of a gradual softening. Powell remains confident about a scenario in which the labor market softens without having to weaken as much as history would indicate as this time it could soften through job openings declining instead of outright large increases in the UR. **We continue to think that the Fed will take the fed funds rate to a 4.75-5.00% peak in 1Q23.** We also anticipate the start of an easing cycle in December 2023 with clear signs that inflation is easing.

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