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Fed Watch

75bp hike a done deal; all eyes on hints of a potential downshift in tightening pace

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November 1, 2022

We think that clear signs of a possible smaller hike in December are still unlikely; labor market data hold the key for future moves

- The Fed is set to raise the fed funds rate by 75 bps to a 3.75-4.00% range on Wednesday -the fourth straight hike of that size. **Given that a super-sized hike is a done deal, the focus will be on hints on what will drive a slowdown in the pace of hikes.** We think that Chair Powell will not be able to provide clear guidance about the most likely size of the December hike, not only because it will depend on upcoming data -two more monthly job market data and two more inflation readings-, but also considering that a wide consensus within the FOMC on the next steps seems still unlikely at this moment in which some Fed officials have just begun to coincide on the importance of assessing the effects of "cumulative tightening" on the economy and inflation (Table 1). Powell will signal that the Fed will keep its options open for December i.e., the Fed will leave the door wide open for either a fifth 75bp hike or a smaller 50bp hike.

- Given that **signs of a policy shift to a slower pace of hikes are still unlikely, all eyes will be on hints of what the Fed will be looking for in the data to slow the pace of rate hikes and then end the tightening cycle.** Although the labor market has started to rebalance and the inflation peak might be behind, there are still ways to go on both fronts as **there is no conflict between the two mandates.** Recent labor market data point to an ongoing rebalancing. The job creation pace has slowed and job openings have fallen (Figures 1 and 2). Yet, labor demand has to fall much further to catch up with a still constrained supply. This sets a backdrop for wage stickiness. On inflation, rising inventories and improving supply chains in a context of weakening demand points to (much?) lower goods inflation ahead. Lower energy prices and the continued strengthening of the dollar will also continue to put downward pressure on goods prices. In fact, core services inflation is already outpacing core goods inflation because the latter is coming down but the former is rising (Figure 3). The gap will likely widen going forward. Lower goods inflation is a welcome development, but for the underlying inflation trend, the rising core services inflation is more relevant since it depends more on demand factors. Thus, **signs are pointing to short-term core inflation stickiness** at uncomfortable levels.

- **We think that a shift to a slower pace of hikes and then the decision to end the tightening cycle will depend (more) on labor market data.** With inflation set to remain quite high in the short term, and underlying inflation pointing to stickiness ahead, what will drive the Fed to slow the hiking cycle will be signals that the labor market is on a pace of rebalancing. Thus, the most important signal in Chair Powell's remarks will be hints on what the Fed is looking for in the labor market to slow down the pace of tightening and then to stop. Chair Powell will likely signal that inflation will most likely remain very high before the Fed ends the tightening cycle but also that a continued labor market rebalancing will translate to lower wage growth and lower underlying inflation. That is, the Fed's plan is that further labor market weakening will break inflation stickiness and allow them to first slow the pace of hikes and then end the cycle. **Would below-trend job creation be enough to slow the hiking pace? Would job destruction be necessary for the hiking cycle to end?**

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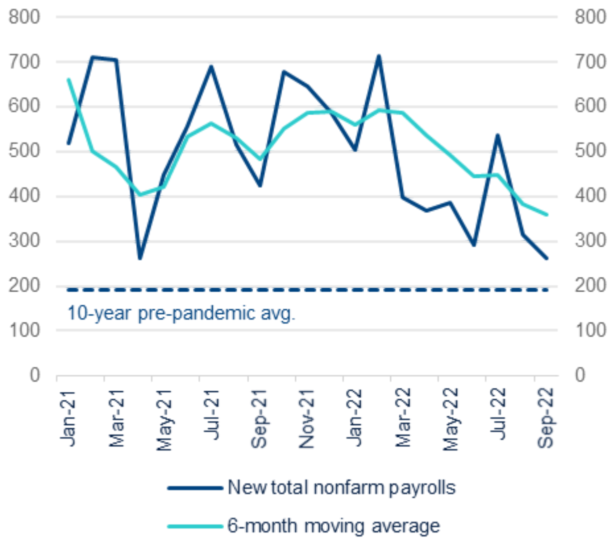
The job creation pace is slowing down and job openings are falling quickly, but labor demand…

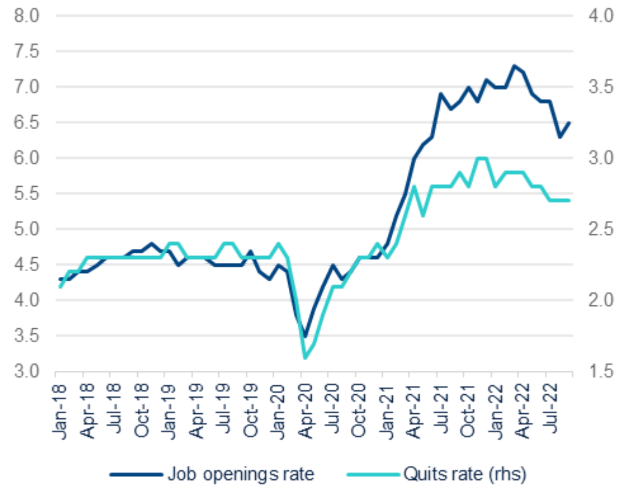
Figure 1. **NONFARM PAYROLL EMPLOYMENT** (SA, THOUSANDS)



Source: BBVA Research based on data by Haver Analytics.

… needs to fall further for the labor market to rebalance and for core services inflation to peak

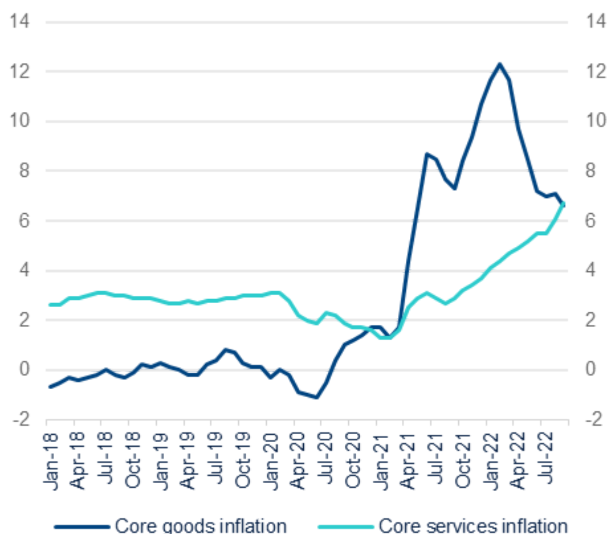
Figure 2. **JOB OPENINGS & QUITS RATES** (%)



Source: BBVA Research based on data by Haver Analytics.

Core goods inflation rapid easing will not be enough to bring core inflation down to 2.0%

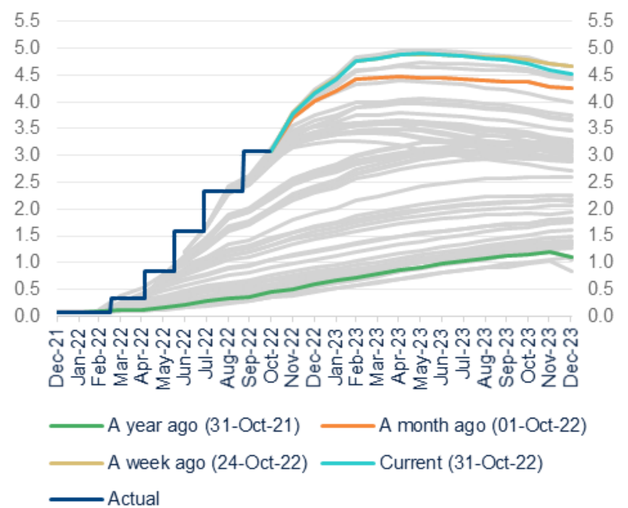
Figure 3. **CORE GOODS AND SERVICES INFLATION** (%)



Source: BBVA Research based on data by Haver Analytics.

The Fed will leave the door wide open for either a fifth 75bp hike or a smaller 50bp hike

Figure 4. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



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

Fed officials continued to communicate the importance of keeping rates high for a long period, although in recent weeks the debate on the importance of considering a pause seemed to begin to open up

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

Relevant remarks on the path of monetary policy
John Williams (New York). At the 2022 US Hispanic Chamber of Commerce National Conference (see), Williams said that the FOMC is taking strong actions to bring inflation down. He noted that we are already seeing some of the effects of tighter monetary policy as broad measures of financial conditions, including borrowing and mortgage rates and equity prices, have become less supportive of spending, which has led to a decline in activity in the housing market and signs of slowing in consumer and business investment spending. He expects real GDP to be close to flat this year and to grow modestly in 2023. He also anticipates that the unemployment rate will rise to around 4.5% by the end of 2023. He expects inflation will decline to about 3% next year, while bringing down underlying inflation will take longer.
Michelle Bowman (Board). At the Money Marketeers of New York University (see), Bowman said that her view continues to be that sizable increases in the target range for the federal funds rate should remain on the table if there are no signs that inflation is moving down. She said that if inflation starts to decline, a slower pace of rate increases would be appropriate. She also pointed out that to bring inflation down in a consistent and lasting way, the federal funds rate will need to move up to a restrictive level and remain there for some time, but that it is not yet clear how high the Fed will need to raise the federal funds rate and how much time will pass before we begin to see inflation moving back down in a consistent and lasting way.
Lael Brainard (Board). At a research conference organized by the Fed (see), Brainard noted that inflation is very high and that the risk of additional inflationary shocks cannot be ruled out. She said that monetary policy will need to be restrictive for some time to have confidence that inflation is moving back to target, so Fed officials are committed to avoid "pulling back prematurely", but also noted that risks may become more two-sided at some point. She concluded that proceeding deliberately and in a data-dependent manner will give the Fed room to learn how economic activity and inflation are adjusting to the cumulative tightening.
Christopher Waller (Board). At the University of Kentucky Mark C. Berger workshop series (see), Waller said that he remains focused 100% on reducing inflation as numbers indicate that inflation is far from the FOMC's goal and not likely to fall quickly. He pointed out that the Fed has not yet made meaningful progress on inflation, and that he supports continued rate increases to help restrain aggregate demand until that progress is both meaningful and persistent. He offered some thoughts on the housing market and said that shelter inflation will likely remain high for several months, meaning overall core PCE inflation will continue to be persistently high. He said more tightening needs to be done to bring inflation down meaningfully and persistently, and anticipates additional rate hikes into early next year.
Lisa Cook (Board). At the Peterson Institute for International Economics (see), Cook said that inflation remains stubbornly and unacceptably high. With inflation running well above the Fed 2% longer-run goal, she argued that restoring price stability likely will require ongoing rate hikes and then keeping policy restrictive for some time until there is confidence that inflation is firmly on the path toward the 2% goal. She said that, at some point, as the FOMC continues to tighten monetary policy, it will become appropriate to slow the pace of increases while policymakers assess the effects of cumulative tightening on the economy and inflation.
Philip Jefferson (Board). At a research conference organized by the Fed (see), Jefferson said that restoring price stability may take some time and will likely entail a period of below-trend growth. He said that the full effects of monetary policy take time, and that the FOMC has acted boldly to address rising inflation and is committed to taking the further steps necessary.
James Bullard (St. Louis). At a virtual forum hosted by Barclays and the Centre for Economic Policy Research (see), Bullard said that in terms of many measures the Fed has been failing to achieve the goal of price stability, so in order to get inflation under control the Fed has to deliver more rate hikes and keep them higher for longer. During a virtual discussion at the HSBC Global Emerging Markets Forum (see), he said that inflation probably will not fall in a straight line, which seems to indicate higher policy rates for longer. Later in several interviews (see, see, see), he said that a hotter-than-expected September inflation doesn't necessarily mean the Fed needs to raise interest rates higher than previously projected, though it does warrant continued front-loading through larger 75bp hikes this year, adding that there's a possibility of a good dynamic in 2023 if inflation does start to decline meaningfully.
Susan Collins (Boston). At a virtual event hosted by the Boston Chamber of Commerce (see), Collins said that inflation remains too high and the Fed is doing whatever it takes to get it back to target. She noted that the actions taken by the FOMC since March, together with the guidance provided in the September SEP, illustrate policymakers' resolve to address high inflation expeditiously, and prevent it from becoming entrenched in expectations. The Fed will continue with the hiking cycle until the inflation rate shows signs that it is declining sustainably.
Loretta Mester (Cleveland). At the MIT Golub Center for Finance and Policy (see), Mester noted that the main challenge facing the U.S. economy is unacceptably high inflation. She does not see a case for slowing down on rate rises right now, adding that she thinks that the Fed will have to raise rates higher than the level of 4.6% officials have projected on the fed funds rate next year. Mester also underscored it's better that the Fed err on the side of doing too much rather than too little even if there is an error to be made. Later, at the Economic Club of New York (see), she emphasized that the necessary costs to return to price stability now are much lower than the costs that would have to be borne later if inflation becomes embedded in the economy. Although it is clear that the Fed needs to take the real rates into positive territory and stay there for some time, for Mester the size of rate increases at any particular FOMC meeting and the peak fed funds rate will depend on the inflation outlook.

Source: BBVA Research.

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