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Fed Watch

Fed’s plans to slow the hiking pace bolstered as inflation eased further in November

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Chair Powell will have a hard time convincing the market that it is still too early to think about a policy pivot

- **The Fed is set to slow down the tightening pace tomorrow with a 50bp hike, taking the fed funds rate to a 4.25-4.50% target range, its highest level since late 2007.** On its own, the transition to a slower hiking pace might be interpreted as a dovish pivot, especially since it comes after an extraordinarily fast set of 75bp hikes by which the policy rate was increased by 300 bps in just four FOMC meetings. Fed’s plans to slow the pace of interest rate increases were bolstered after inflation came in better than anticipated and goods disinflation signs mounted. Headline inflation slowed to 7.1% YoY (from 7.7% in Oct), with core inflation easing to 6.0% YoY, driven by core goods which fell (-)0.5% MoM and to a lesser extent by a more moderate 0.4% MoM increase in core services prices. More importantly, leading price indicators in manufacturing surveys suggest that core goods deflation will continue to pick up pace in coming months (Figure 1). Although the Fed will stick to its hawkish tone, inflation is set to ease further and October and November data are comforting.
- **In spite of positive inflation data and signs since the last meeting, to avoid an unwanted further decline in interest rates along the yield curve, Chair Powell will likely accompany the FOMC decision with a still relatively hawkish press conference** that will not be that different from his most recent speech at the Brookings Institution two weeks ago, where he said that it was time to slow the pace of coming interest rate hikes but also reiterated that the terminal rate is likely to be “somewhat higher” than the 4.6% projected in September and that curbing inflation “will require holding policy at a restrictive level for some time” as the labor market remains strong by historical standards and shows “only tentative signs” of rebalancing (Figure 2). The “dot-plot” updated projections will most likely show a terminal rate of about 5.0%. Powell's warning of the risks of prematurely loosening policy has been supported by several Fed officials (Table 1) who in recent weeks have supported the need of keep raising rates but at the same time began to acknowledge that it is prudent to slow down the pace of rate increases given the uncertainty around the effects of cumulative tightening. Updated fed funds forecasts will likely show that the Fed is planning to stay on the sidelines after it takes the fed funds rate to its peak, likely in 1Q23.
- **Chair Powell will face two challenges in the press conference: i) trying to convey a clear hawkish message with signs arising** in the minutes of the last meeting and in recent speeches **that Fed officials no longer hold a consensus view on what to do next**, **and ii) attempting to avoid an unwanted further decrease of interest rates along the curve** by stressing that inflation remains too high and the job of bringing it down is not done, and thus the Fed will stick to it. Chair Powell will stress the updated projections to convey a hawkish message (see below) but the growing weakness in core goods inflation is now difficult for the Fed to ignore (Figure 3).

- **The updated Summary of Economic Projections (SEP) will likely try to reinforce a still hawkish Fed tone through a higher than expected end-2023 policy rate and an economic scenario aligned with a slightly more hawkish stance.** The 2023 year-end projection for the fed funds rate will likely be around 5% (4.6% in September), which would signal that i) tomorrow's 50bp hike will likely be followed by at least two smaller (25bp) hikes in early 2023, and that ii) the Fed is planning on keeping rates steady for the whole year. Updated projections for 2024 and 2025 are more uncertain (3.9 and 2.9% in September), but with a slightly more restrictive stance in the near term, they will likely not change significantly or will even decline, outlining the start of a debate among FOMC participants on the need for an eventual shift towards a more neutral stance. The new set of projections will also update growth, unemployment rate (UR) and inflation forecasts. Consistency with a somewhat more restrictive stance in the near term will likely mean the UR projections will slightly exceed 4.5% in 2023 and 2024 (up from 4.4% in September). A slightly downward revision to the 2023 real GDP growth projection is likely (1.2% in September), with the Fed still bent on the possibility of a soft landing. Lastly, 2023 headline and core PCE inflation will likely be slightly revised to the upside and projections for 2024 and 2025 will likely remain unchanged.

- **Overall, although the Fed will stick to a hawkish tone and updated projections will show higher rates, inflation easing will most likely pick up in coming months.** That together with divisions arising within the FOMC will keep alive the discussion on both the terminal rate (i.e. will the Fed take rates to 5.0% in March or could move to the sidelines after hiking to 4.75% in February?) and for how long will a restrictive stance be needed (i.e. if inflation eases rapidly to c. 3.0% YoY and the economy falls into a recession in 1H23, will the Fed pivot and start an easing cycle in 3Q?). This last scenario is what the futures markets appear to be expecting (Figure 4). **For now, we stick with our 4.75%-5.00% peak rate forecast and we continue to think that the Fed will move to the** sidelines **until late 2023, but the discussion in 2023 will likely shift from (high) inflation to (weak) growth.**

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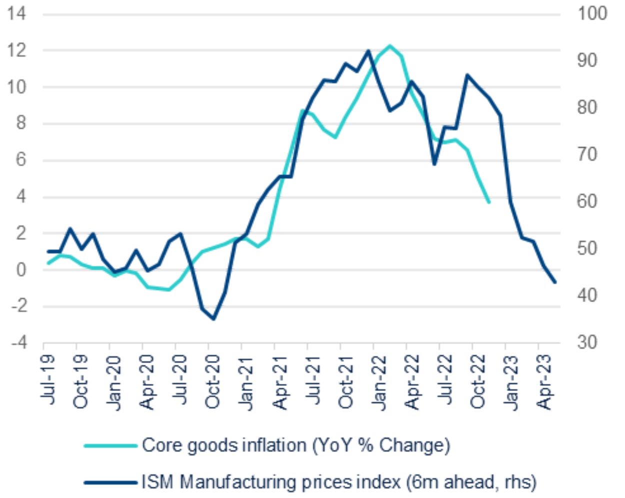
Leading price indicators suggest that core goods deflation will continue to pick up its pace ahead

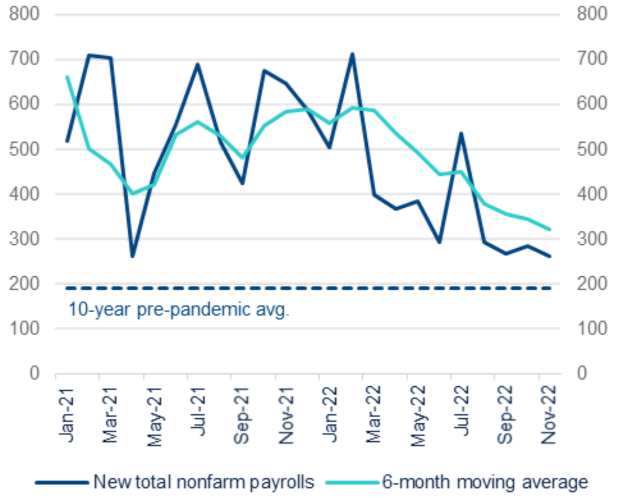
Figure 1. **CORE GOODS INFLATION AND ISM MANUFACTURING PRICES INDEX**



Source: BBVA Research based on data by Haver Analytics.

The labor market remains strong and shows "only tentative signs" of rebalancing

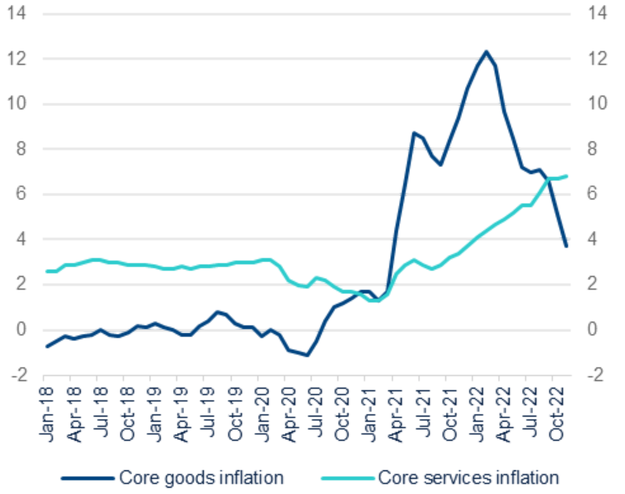
Figure 2. **NONFARM PAYROLL EMPLOYMENT** (SA, THOUSANDS)



Source: BBVA Research based on data by Haver Analytics.

Growing evidence of core goods easing inflation is now difficult for the Fed to ignore

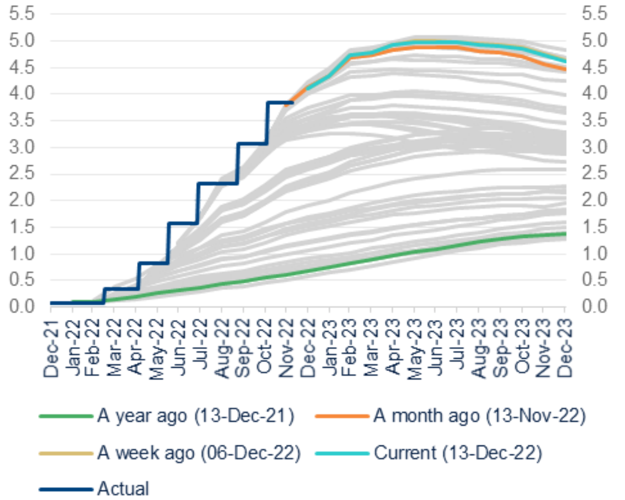
Figure 3. **CORE GOODS AND SERVICES INFLATION** (%)



Source: BBVA Research based on data by Haver Analytics.

Will the Fed take rates to 5.0% in Mar or move to the sidelines after hiking to 4.75% in Feb?

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.

Powell's warning of the risks of prematurely loosening policy has been supported by most Fed officials; at the same time, they began to acknowledge that it is now prudent to slow down the hiking pace

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

Relevant remarks on the path of monetary policy
Jerome Powell (Board, Chair). During a speech at the Brookings Institution (see), Powell said that it was time to slow the pace of coming interest rate hikes but also reiterated that the terminal rate is likely to be "somewhat higher" than the 4.6% projected in September and that curbing inflation "will require holding policy at a restrictive level for some time." Powell said that it remains an open question "how much further [the Fed] will need to raise rates to control inflation, and the length of time it will be necessary to hold policy at a restrictive level." He noted that the labor market shows "only tentative signs" of rebalancing.
John Williams (New York). At a conference in Switzerland (see), Williams reviewed some theoretical and empirical facts of inflation expectations. He noted that even though inflation uncertainty has increased, longer-run inflation expectations in the US have remained "remarkably stable" at levels consistent with the FOMC's longer-run goal. Then at the annual US Treasury Market Conference hosted by the New York Fed (see), he remarked that strong and decisive actions are needed in order to restore "price stability" and to ensure economic stability.
Lael Brainard (Board). At a BIS conference in Switzerland (see), Brainard offered some lessons from the pandemic and the war about supply shocks, inflation, and monetary policy. She explained that a protracted series of adverse supply shocks could persistently weigh on potential output or could risk pushing inflation expectations above target in ways that call for monetary policy to tighten for risk-management reasons. Additionally, she reflected on the possibility that longer-term changes (such as those associated with labor supply, deglobalization, and climate change) could reduce the elasticity of supply and increase inflation volatility into the future.
Christopher Waller (Board). During a speech at the 59th Annual Economic Forecast Luncheon in Phoenix, Arizona (see), Waller noted that monetary policy is barely in restrictive territory and more interest rate hikes are needed to get inflation down. In his opinion, both the terminal rate and the way the Fed will get there will depend on progress toward the inflation goal and the economy's response to "cumulative tightening." He said he would be more comfortable considering stepping down to a 50bp hike in December, though he noted this must not to be seen as a policy pivot as it would still be a very significant tightening action. Finally, he pointed out that further rate hikes through 2023 will be appropriate if the Fed is to get inflation "down in a meaningful and persistent way."
Lisa Cook (Board). At the Detroit Economic Club (see), Cook said that "inflation is unacceptably high and must be [the] primary focus." Although demand has declined in interest rate sensitive sectors such as housing, consumer spending has remained resilient supported by labor income growth and still-elevated savings. She agrees with the need for ongoing rate hikes in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time. In addition, she noted that the terminal rate and pace of monetary policy will depend on observed progress in bringing down inflation, so, given the high level of uncertainty, it would be prudent to move in "smaller steps."
Philip Jefferson (Board). Jefferson delivered a speech at a conference in Minneapolis (see). He remarked that "strong demand and a variety of supply shocks have contributed to the fastest increase in consumer prices since the early 1980s." High inflation has negative effects on social welfare, such as eroding the purchasing power of income and savings, hence Jefferson stressed the importance of returning to price stability to achieve "a long and sustained expansion". In his view, while monetary policy is not designed to address important welfare issues, monetary policymakers must understand the many and varied conditions that can make policies more effective in fostering prosperity; today it will only be achieved by returning to low and stable inflation.
James Bullard (St. Louis). During an event hosted by Greater Louisville Inc. (see), Bullard noted that inflation has been exceeding the FOMC 2% target for more than 18 months. Using a Taylor-type monetary rules approach he addressed the question of what is a "sufficiently restrictive" level of the policy rate, pointing out that even under the most "dovish" interpretation monetary policy is not restrictive enough, hence the Fed has to keep raising rates. On the other hand, he stated that although so far, the change in monetary policy stance appears to have had limited effects on observed inflation, market pricing suggests disinflation is expected in 2023. Later, in an interview with MarketWatch (see), Bullard reiterated his view to raise the interest rate to a level of at least the bottom end of a 5 to 7% range in order to bring inflation down. He foresees further rate hikes through 2023 and for monetary policy to remain in its restrictive stance until 2024, with below-trend growth in 2023.
Susan Collins (Boston). In a conversation with members of the Brookings Institution via webcast (see), Collins said the FOMC is moving from the initial policy phase focused on moving rates into restrictive territory very quickly, to a second phase with a focus on determining how high rates need to go to return inflation to the 2% target over a reasonable horizon. She noted that going forward the Fed has to assess how the economy is responding to cumulative tightening and must balance the risk of doing too little, letting inflation remain elevated and become entrenched in expectations, against the risk that policy actions excessively slow down the economy. Later, at a conference hosted by the Boston Fed (see), she said that returning to price stability will require further rate hikes, followed by a period of holding rates at a sufficiently restrictive level for some time. She expressed confidence that the Fed could disinflate the economy without a significant downturn in the labor market.
Loretta Mester (Cleveland). In a speech at Princeton University (see), Mester said that the FOMC had been focusing on how quickly to get to a restrictive stance, but now "the focus can shift to the appropriate level of restrictiveness that will return the economy to price stability." She reiterated her view that policy rate will need to become more restrictive and remain restrictive for some time. Moreover, she noted that while returning to price stability will not be without some pain, from a risk-balance approach, the larger risks are coming from tightening to little. Then during an interview with CNBC (see), she said that despite "some good news on the inflation front" the Fed has more work to do to see inflation decline on a sustained path back to 2%. She also expressed her openness to consider a slowdown in the pace of tightness and be very deliberate in setting monetary policy at upcoming meetings.

Source: BBVA Research.

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