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Fed Watch

Will financial instability concerns outweigh Fed's focus on inflation?

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The Fed will stick to its resolve to bring inflation down with another 25bp hike but signal more uncertainty on future decisions

- **Earlier this month, Chair Powell suggested during his semiannual testimony before the Congress that the FOMC would be discussing whether to raise the fed funds rate by 25 or 50 bps** (i.e., whether to pick up its hike pace again) by saying that the Fed was "prepared to increase the pace of rate hikes" if warranted by economic data. He also said that the Fed would need to lift the fed funds rate beyond the 5.1% level projected in December's dot plot. This hawkish tone, echoed by several voting FOMC members during the intermeeting period (Table 1), came after the US economy entered 2023 on a strong footing. Job creation in February (+311k) was not as strong as in January (+504k) but came in above expectations once again. Headline and core CPI inflation edged down in February (to 6.0 and 5.5%, from 6.4 and 5.6% in January), but core services ex-housing inflation—the component the Fed is most concerned about right now—is not yet showing clear signs of easing (Figure 1). Given that neither jobs nor inflation latest figures point to a significant economic slowdown, the odds of a 25 or 50bp hike should be roughly balanced based solely on incoming macro data.

- **Yet the dilemma for the Fed changed following broader financial stability concerns triggered by the fallout of Silicon Valley Bank (SVB) and Signature Bank.** FOMC participants didn't have the opportunity to react publicly to these events since the FOMC entered a blackout period the day after the collapse of SVB. This led to high uncertainty on the Fed's next move and to extremely volatile swings in the Treasury market, with the 2-year Treasury yield declining by c. 60 bps in a single day (Figure 2). Tomorrow's decision will likely be between a 25bp hike and leaving rates unchanged temporarily. We think that a 25bp hike is more likely than not. **We stick with our call that the Fed will take the fed funds rate to a 4.75-5.00% range tomorrow to signal its resolve to bring inflation down**. A bigger 50bp hike is now likely off the table. This is because the Fed will likely assess that recent shifts in financial markets have on balance tightened financial conditions and along with "animal spirits" might contribute to slow demand ahead (i.e., current risks are somewhat more disinflationary). Albeit risks linger, concerns eased somewhat following a quick response from authorities—which guaranteed all deposits from the two troubled banks and launched a Banking Term Funding Program aimed at stabilizing the liquidity position of all banks facing problems—and further eased after Treasury Secretary Yellen said the government was prepared to provide further guarantees of deposits if the banking crisis worsens[1]. The decisive actions and signals along with eased concerns may pave the way for the Fed to hike interest rates given that the economy is not cooling as hoped and thus, officials have insisted they have more to do.

[1] "The steps we took were not focused on aiding specific banks or classes of banks. Our intervention was necessary to protect the broader U.S. banking system [...] and similar actions could be warranted if smaller institutions suffer deposit runs than pose the risk of contagion".

- **We think that significant upward revisions to the "dot-plot" in the updated Summary of Economic Projections are now less likely.** Some think that the Fed will not raise rates tomorrow (see). Although fed funds futures (Figures 3 and 4) are pricing in a 25bp hike (+80% odds), they also suggest that the Fed will relatively soon need to reverse course and start to cut rates (+90% odds of a fed funds target range below 4.75-5.00% by year end). The odds of the Fed moving to the sidelines temporarily to shore up confidence are now low but not zero. This is because if the Fed ends up leaning to standing pat, it would be careful to signal that it is a pause and not the end of the cycle. What seems more likely in our view is that the Fed likely became more cautious (i.e., somewhat less hawkish) during the blackout period. Before bank-related concerns, officials had signaled that they would likely revise up the median projected fed funds rate by around 50 bps to 5.6% from 5.1% in December (i.e., to a 5.50-5.75% target range). Now, we still think it will increase but probably only by around half of what was previously signaled. Overall, we think that the Fed will acknowledge financial risks and be less clear on the future path of interest rates, which will depend on both the need for the economy to cool and the evolution of risks in the banking system.

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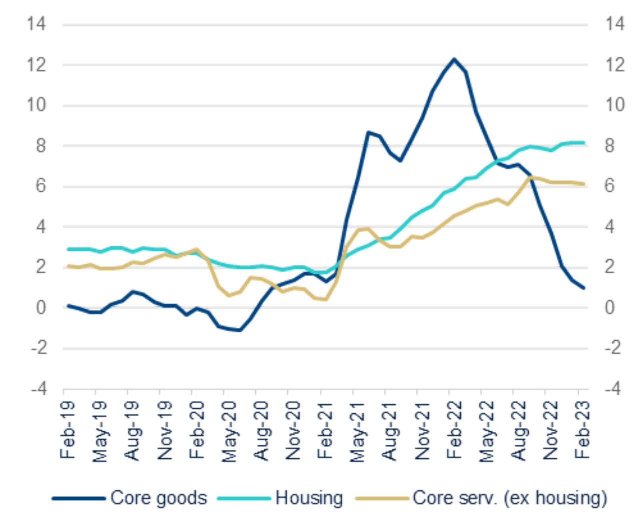
Housing inflation is set to ease but core services inflation ex-housing is not softening yet

Figure 1. **SELECT COMPONENTS OF CPI INFLATION** (YoY % CHANGE)



Source: BBVA Research based on data by Haver Analytics.

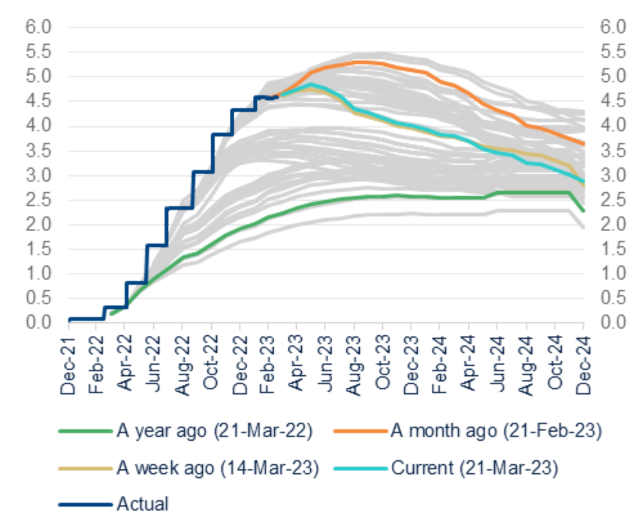
Financial stability concerns led to extremely volatile swings in the Treasury market

Figure 2. **2-YEAR TREASURY YIELD DAILY CHANGE** (% AND BPS)

The gray line and area indicate the federal funds rate target.
Source: BBVA Research based on data by Haver Analytics.

Although fed funds futures are pricing in a 25bp hike, they also suggest that the Fed…

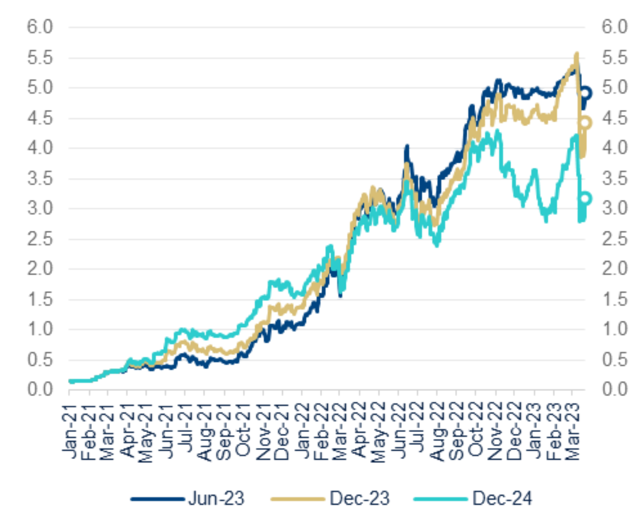
Figure 3. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



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

… will relatively soon need to reverse course and start to cut rates before year end

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



Source: BBVA Research based on data by Bloomberg.

Before SVB collapse, several FOMC members acknowledged that the US economy entered 2023 on a strong footing and nurtured the idea that this month's debate would be between a 25 or a 50bp hike

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

Relevant remarks on the path of monetary policy
Jerome Powell (Board). In his semiannual testimony to the Congress (Mar 7-8, see), Powell said that rates will likely rise more than previously expected as the process of getting inflation back down to 2% has a long way to go and is likely to be bumpy. He explained that the latest stronger-than-expected economic data suggests that the ultimate level of interest rates is likely to be higher than previously anticipated, adding that if the totality of the data were to indicate that faster tightening is warranted, we would be prepared to increase the pace of rate hikes.
Michelle Bowman (Board). At a conference hosted by the American Bankers Association in Florida (Feb 13, see), Bowman said she expects that ongoing increases will be appropriate to bring the fed funds rate to a sufficiently restrictive level and that it will need to remain there for some time to restore price stability, which is still far from being achieved. She noted that while there are costs and risks to tightening monetary policy, costs and risks of allowing inflation to persist are far greater.
Christopher Waller (Board). At Arkansas State University (Feb 8, see), Waller noted that while some believe inflation will come down quickly this year, he's not seeing signals of this quick decline in the economic data. He said to be prepared for a longer fight to get inflation down and expects the Fed will need to keep a tight stance of monetary policy for some time to slow activity further in 2023. At the Mid-Size Bank Coalition of America (Mar 2, see), Waller said that he would endorse raising the fed funds rate a couple more times (to a projected terminal rate between 5.1 and 5.4%) if inflation and employment data shows sign of moderation, which would suggest that the February's "hot data releases" were just a bump in the road and that progress is continuing.
Philip Jefferson (Board). At the US Monetary Policy Forum in New York (Feb 24, see), Jefferson discussed a paper titled "Managing Disinflations" by Cecchetti et al. He explained that one of the authors' policy takeaways is that despite the rapid tightening to date, additional monetary policy tightening is likely to prove necessary to achieve 2% inflation by 2025 and is likely to lead to a mild recession. He noted that inflation in core services excluding housing has remained stubbornly high, and that the outlook for this category will likely depend in large part on whether labor demand comes into better balance with labor supply and growth in nominal labor costs. At Harvard University (Feb 27, see), Jefferson reiterated the uncertainty surrounding core services (excluding housing) inflation.
John Williams (New York). At the New York Bankers Association (Feb 14, see), Williams explained that declines in goods inflation will be not enough to bring inflation down on a sustained basis. He said there is still some way to go to achieve price stability, and it will likely entail a period of subdued growth and some softening of labor market conditions. He expects real GDP to grow by 1% this year and the unemployment rate to edge up to between 4 and 4.5%. He expects PCE inflation to fall to 3% in 2023, before moving closer to 2% in the next few years.
Patrick Harker (Philadelphia). At La Salle University (Feb 14, see), Harker pointed out that rates are now at a level that allows the FOMC to slow down and proceed cautiously. At some point this year, he expects that the policy rate will be restrictive enough that the FOMC will hold rates in place and let monetary policy do its work. He expects core inflation to fall to 3.5% this year, and to 2.5% and 3% in 2024 and 2025, respectively. He is not forecasting a recession, and expects a 1% real GDP growth this year before climbing back up to trend growth of about 2% in 2024 and 2025. He thinks we will see a very slight uptick in unemployment, probably topping out modestly above 4% this year.

Source: BBVA Research.

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