Fed Watch

Fed's debate on how high should rates go is likely to end soon

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The strength of the economy and the job market will refrain the Fed from ruling out the chance of an additional rate hike this year

- **The FOMC will likely decide to "skip" raising rates as it did last June, leaving the fed funds rate unchanged at its current 5.25-5.50% target range.** All eyes will be on the updated Summary of Economic Projections (SEP). All relevant underlying inflation measures have come down quicker than anticipated since the last time the Fed updated its projections (Figure 1). In fact, if we remove shelter from the CPI, the rate at which inflation has risen on an annualized basis over the last six months is below 2.0%. Yet, the economy and the labor market have remained resilient. The Fed will likely feel encouraged by recent inflation data but also cautious because even if the economy and the labor market are cooling gradually (Figure 2), demand and supply still have room to come into better balance. The Fed can sit and wait for more data to see if inflation continues to convincingly come down and end the hiking cycle in November. For now, the FOMC will skip and leave its options open.

- **FOMC members reaffirmed the Fed's data-dependent strategy, as most of them welcomed the recent evolution of core inflation while also conveyed they remained vigilant of inflation risks stemming from a still strong economy and labor market** (Table 1). Chair Powell's comments at Jackson Hole on August 25 were less hawkish than those from a year ago. After 500 bps of hikes since March 2022 and amid a better-than-expected evolution of PCE core inflation more recently, Chair Powell stated that FOMC members are now in a position to "proceed carefully" as they continue to seek the peak at which the federal funds rate would reach a "sufficiently restrictive" stance. The strength of the economy (real GDP, though slightly revised down, was 2.1% annualized in 2Q23, well above the Fed's 1.8% longer-run estimate) as well as various labor market indicators (the job openings to unemployed ratio at a still strong 1.5), has prevented the Fed from having more confidence that the current level of restraint is sufficient.

- **The Fed will leave its doors open for an additional rate hike before year-end; a slightly dovish majority could result in a slightly lower projected fed funds rate for 2024.** This means the 2023 year-end median forecast for the fed funds rate will likely remain unchanged at 5.6% in the updated SEP, but changes in the dot-plot could show that Fed officials are less convinced about the need for an additional hike in November, thus signaling that the cycle peak could have already been reached. Whether the Fed decides to hike or not will depend on the data to be released before the November meeting. It is likely that the Fed decides to pause at the current 5.25-5.50% if the recent disinflationary trend continues in the following months, but as Chair Powell pointed out, "additional evidence of persistently above-trend growth or evidence that the tightness in the labor market is no longer easing [...] could warrant further tightening of monetary policy." Under this backdrop, the decision will depend on the assessment of risks of doing too much or doing too little, which the Fed has recently signaled are more balanced now. It is less clear if the rate projection for the end of 2024 will change

significantly. June's dot plot ranged from a 3.6 to a 6.1% individual rate projection, and a 4.6% median projection shared by two FOMC participants. A downward revision below 4.6% from only one member could be enough to bring down the current median forecast. Even if the current 4.6% median forecast is not revised down, the implicit average will most likely move down with some officials projecting somewhat lower rates by year-end 2024. Updated projections might show stronger growth but inflation easing faster than previously expected. Overall, we expect market rate expectations (Figures 3 and 4) to shift somewhat to the downside after the meeting.

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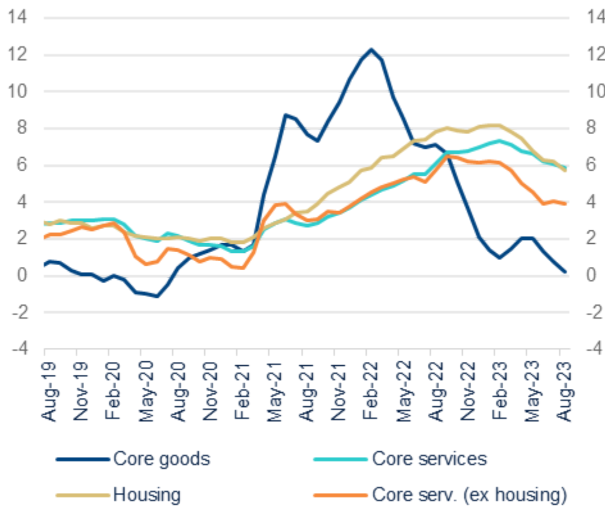
The Fed will likely feel encouraged by recent inflation data but cautious because even if the…

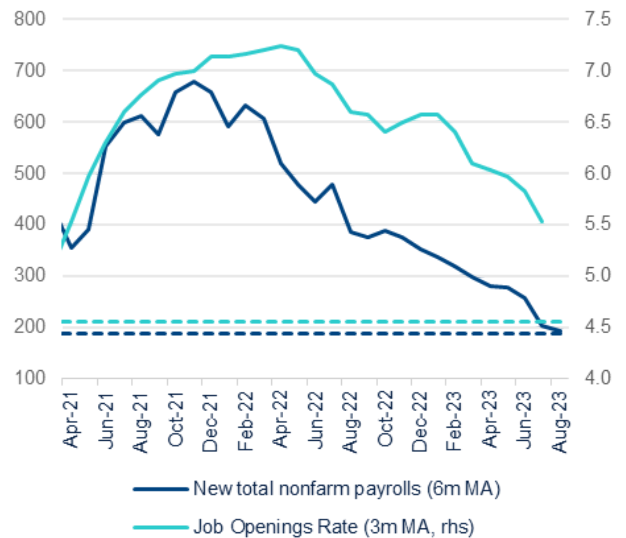
Figure 1. **SELECT COMPONENTS OF CPI INFLATION** (YoY % CHANGE)



Source: BBVA Research based on data by Haver Analytics.

… economy is cooling, demand and supply still have room to come into better balance

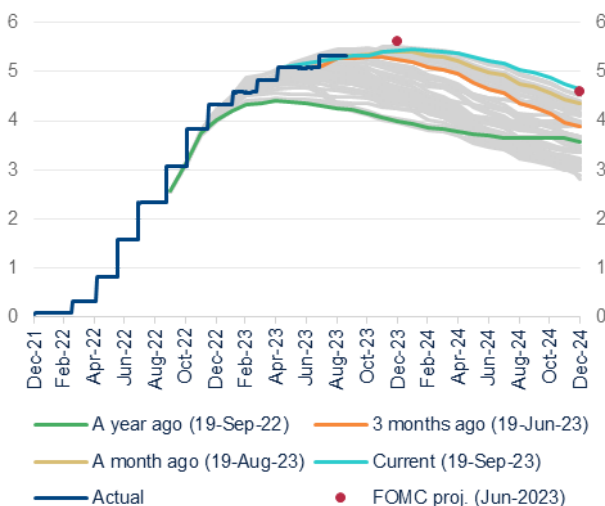
Figure 2. **SELECT LABOR MARKET INDICATORS** (THOUSANDS AND %)



Dashed lines indicate pre-pandemic 10-year (nonfarm payrolls, lhs) and 2-year (job openings rate, rhs) averages.
Source: BBVA Research based on data by Haver Analytics.

Overall, we expect market rate expectations…

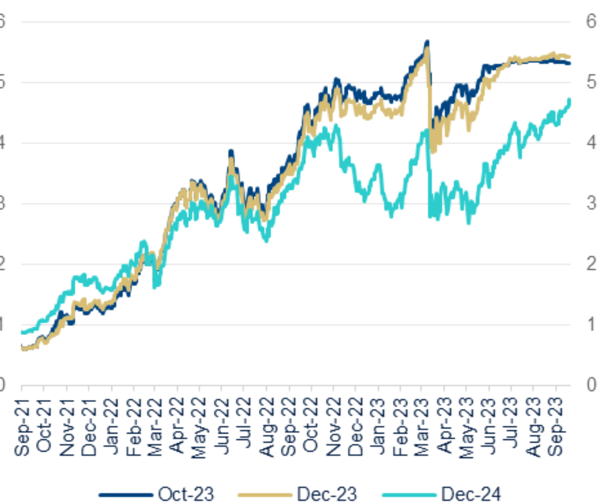
Figure 3. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



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

… to shift somewhat to the downside after the meeting

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



Source: BBVA Research based on data by Bloomberg.

Officials reaffirmed the Fed’s data-dependent strategy; most of them welcomed the recent evolution of core inflation, but remain vigilant about the risks stemming from a still strong economy and labor market

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

Relevant remarks on the path of monetary policy
Jerome Powell (Board). At the Jackson Hole symposium (August 25, see), Powell said that although lower-than-expected core inflation in June and July was a welcome development, it is only the beginning of what it will take to build confidence that inflation is moving down sustainably toward 2%. He noted that as pandemic-related distortions continue to unwind, restrictive monetary policy will likely play an increasingly important role ahead. He stressed that the uncertainty around a precise level of monetary policy restraint underscores the need for agile policymaking. While he judged the FOMC is in a position to proceed carefully given how far they have come, additional evidence of persistently above-trend growth or no-longer-easing tightness in the labor market could put further progress on inflation at risk and could warrant further tightening.
Michelle Bowman (Board). At a meeting sponsored by the Kansas Bankers Association (August 5, see), Bowman noted there has been some progress on inflation as June’s CPI suggested monetary policy is contributing to lower inflation but, at the same time, she said the economy and the labor market have remained strong. After supporting July’s FOMC decision, she said she expects that additional rate increases will likely be needed if the incoming data indicate that progress on inflation has stalled, but also reiterated that monetary policy is not on a preset course. At a Fed Listens event hosted by the Federal Reserve Bank of Atlanta (August 7, see), she added that she will be looking for evidence that inflation is on a consistent and meaningful downward path as she considers whether further increases in the federal funds rate will be needed, and how long the federal funds rate will need to remain at a sufficiently restrictive level.
Christopher Waller (Board). He commented to the media (September 5, see) that the most recent jobs and PCE inflation readings will allow the Fed to proceed carefully as there’s nothing to suggest the FOMC needs to do anything imminent anytime soon. Questioned on his view of the likelihood of a soft landing, he said that while the way that data is coming in is looking pretty good, recessions are often caused by shocks that come out of nowhere. He said that the FOMC would be in pretty good condition if it keeps driving inflation down for the next few months by 0.2% MoM. In his opinion, risks are now more evenly balanced between doing too much or doing too little, though he doesn’t think one more hike would necessarily throw the economy into recession if they did feel they need to do one. However, with the labor market still pretty strong, it’s not obvious that the Fed is in real danger of doing a lot of damage to the job market even if it raises rates one more time.
John Williams (New York). He commented to the media (September 7, see) that even though monetary policy is in a good place and the Fed has done a lot, doubts persist about whether a restrictive stance has already been achieved. He pointed out that FOMC participants will keep watching the data carefully and will be asking themselves about the need to maybe raise rates again to make sure that they are keeping a steady progress in terms of shrinking imbalances in the labor market and bring inflation back down.
Austan Goolsbee (Chicago). He commented to the media (September 7, see) that FOMC participants are very rapidly approaching the time when their argument is not going to be about how high should the rates go but about how long they need to hold rates steady before they’re sure that they’re on the path back to the target.
Patrick Harker (Philadelphia). At an event hosted by the Philadelphia Business Journal (August 8, see), Harker said he believes that, absent any alarming new data, the FOMC may be at the point where they can be patient and hold rates steady, but also stressed that he does not foresee any likely circumstance for an immediate easing of the policy rate. He said he expects only a modest slowdown in economic activity to go along with a slow but sure disinflation, with core PCE inflation declining to just below 4% by the end of 2023 before falling below 3% in 2024. He commented to the media (August 24, see) that recent strong readings of GDP growth and declining inflation are likely to be explained by the same dynamics that were in place back in 2019 before the pandemic. He said not to be overly concerned about the recent spike in long-term interest rates. He reiterated his view that the FOMC have probably done enough as two things are already going on: the fed funds rate is at restrictive levels and the balance sheet is still being reduced, which is also removing accommodation.
Neel Kashkari (Minneapolis). He commented to the media (August 15, see) that he’s not ready to say that they’re done, as even though the Fed has made some progress, rates may still need to go higher. However, he acknowledged recent signs of easing inflation are positive signs that allow him to take a little bit more time to get some more data before the Fed decides whether they need to do more.
Lorie Logan (Dallas). She commented to the media (September 7, see) that skipping an interest-rate hike in September may be appropriate, but also that skipping does not imply stopping, as further evaluation of the data and the outlook could confirm that the Fed needs to do more to extinguish inflation.

Source: BBVA Research.

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