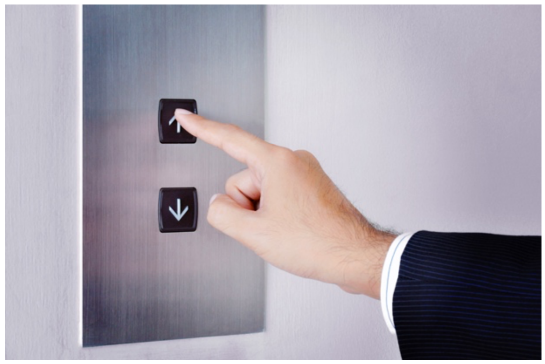
November 7, 2022

Acknowledging Lag Effect, the Fed Indicates More Work to be Done and Ultimately Higher Rates

Economic INSIGHT



As expected, the Federal Reserve (Fed) opted to raise rates an additional 75 basis points (bps) earlier this week. The November statement focused on the lag in which policy impacts the real economy, suggesting a possible "*pivot*" to smaller-sized rate hikes may soon be deemed appropriate, even as early as next month. Later, however, Federal Reserve Chairman Jerome Powell seemed to walk back an assessment of the Committee taking a less aggressive approach to taming inflation, insisting there is a significant amount of work still to be done.

The Fed has indicated that at some point it would be appropriate to initiate smaller-sized rate hikes to assess the impact of earlier initiatives. With an unemployment rate at a five-decade low and prices still near a four-decade high, is that point now? Arguably no, not yet. However, there are some members at the Fed anxious to tamp down this more aggressive pace of action sooner rather than later.

THE FOURTH INNING

On Wednesday, the Federal Reserve affirmed its commitment to reinstating price stability, "*the bedrock*" of the economy. Announcing a fourth-round 75bp increase, the Fed increased the upper bound of the federal funds target range from 3.25% to 4.00% with 375 bps of tightening now under its belt.

Ahead of the November rate decision, the market was fully pricing in the latest "*super-sized*" hike. But while the latest rate adjustment was arguably already "*baked into the cake,*" going forward the pathway of policy is a bit less certain. As such, market participants were looking very closely at the language in the November statement and hanging on Powell's every word for any indications as to the Fed's next move and longer-term outlook for rates.

While Powell far from tipped his hat, reiterating that "*no decision has been made*" regarding future rate increases, the market nevertheless is increasingly convinced a

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slower pace of policy adjustment is on the horizon. At this point, a 50bp hike is now in play for December at a 52% probability.

A LAG IN THE STATEMENT

One of the key phrases investors were searching for in the November statement was "*ongoing rate increases would be appropriate*" to bring rates to a level that is "*sufficiently restrictive to return inflation to 2% over time*." While the Federal Open Market Committee (FOMC) did maintain this guidance, this language was somewhat softened by an inclusion of new wording emphasizing the lagged effect with which monetary policy affects economic activity and inflation. Taking that into account when considering the longer-run pathway for policy, the speculative view is that the Fed may be willing to reduce the size of rate hikes sooner rather than later to assess the impact of nearly 400bps of earlier policy adjustments.

"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." -November 2 FOMC Statement

A CHAIRMAN REDIRECT: RATES WILL BE HIGHER THAN PREVIOUSLY EXPECTED

But while the November statement brought additional attention to the gap between policy adjustments and the impact on the economy, during the press conference, Powell redirected the focus to the still-elevated level of prices and the need for further policy adjustments. While he acknowledged that it would likely be appropriate to *"slow the pace of increases*" potentially as soon as the next meeting, he also noted the appropriate time could be February or later. At this point, there is still a need for ongoing rate hikes. And furthermore, the ultimate level of rates, he said, *"will be higher than previously expected.*"

In fact, when asked about the potential for tightening "*too much*," Powell responded two-fold. First, the Fed needs to continue to raise rates until "*real rates were positive across the curve, clearly*," he said, underscoring the notion there is "*more work to be done*." Second, the risk is not that the Committee over tightens but that the Committee does too little. "*If we over tighten,*" he said, "*we have policy tools to support the economy*." The larger risk is the Fed stops short of taming elevated price pressures, at which point, Powell lamented, inflation could become entrenched in the economy.

Furthermore, in addressing the lag effect of monetary policy, Powell first acknowledged that as the Fed moves into restrictive policy, "*it's appropriate to think more about lags*." That being said, there is an argument, he added, to suggest the lag time between changes in monetary policy and the impact on the broader real economy is now much reduced relative to previous cycles given financial market conditions move in

GLOSSARY

YoY – Year over Year

FOMC – Federal Open Market Committee

SEP – Summary of Economic Projections

UST – U.S. Treasury

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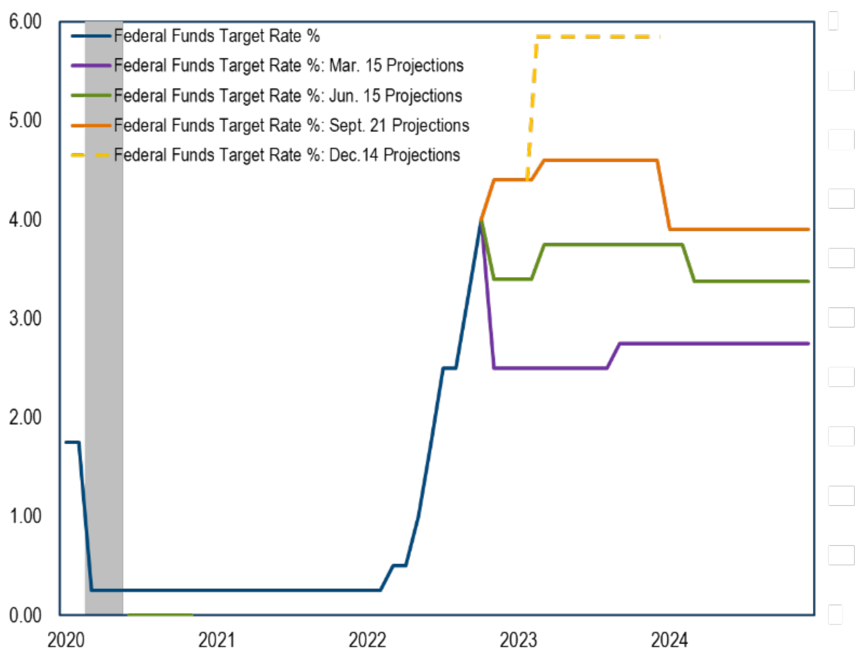
anticipation of Fed policy. In other words, the economy is expectedly already responding to earlier rate hikes, limiting the need for the Fed to adjust the pace of policy in order to assess the response to earlier tightening. "*So the lag effect*," he said "*may be much shorter*." "*The lag time is unclear. We don't know. It's highly uncertain*," he added.

Additionally, Powell added, that often when policy makers talk about lags there is a deviation in market sentiment anticipating a potential pause in policy initiatives. While tolerating a discussion of the timeline for a potential reduction in the size of incremental hikes, Powell was clear it is *"very premature to be thinking about or talking about pausing – we have a ways to go*."

FULL SPEED AHEAD

While the Fed is increasingly aware of the – uncertain – lag of monetary policy and the *eventual* need for a slower pace of rate hikes, Powell did little to convince the market that time is now. Emphasizing instead that more tightening is needed, the economy is slowing but remains modest, and the risk of Fed policy doing too little, this time to downshift policy may be well beyond the upcoming December meeting. The Committee remains flexible and policy will reflect the current evolution of the data and inflation.

The U.S economy is clearly losing steam in some areas particularly in the housing market and amid consumers struggling to stay afloat as rising prices reduce purchasing power. The labor market, meanwhile, remains still solid with the latest read on payrolls showing a 261,000 increase. Additionally, against the backdrop of a stronger-than-expected rise in the third-quarter activity, with inflation well above earlier expectations, the Committee does appear well positioned to continue with a robust pace of rate increases and furthermore, revise higher its expectations for rates heading into 2023, well above what the Fed and the market are currently anticipating.



Source: Federal Reserve Board/Bloomberg

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As of the latest September Summary of Economic Projections, or SEP, the Fed is anticipating a 4.4% federal funds rate at the end of the current year and reaching 4.6% sometime next year. The Committee has, however, already revised up its forecast for rates by nearly 200bps since the initial March forecast. With inflation markedly above the Fed's expected year-end level and even further above the Committee's 2% target range, the Fed will likely revise expectations higher for both rates and inflation a fourth time in the final SEP release of 2022.

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