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MARKET SIGHT LINES

No March Change in Monetary Policy Will the Federal Reserve Paint Itself into a Corner?

By Michael O'Keeffe, *Chief Investment Officer*

Recent inflation reports disappointed to the upside, meaning inflation still hovers above the Federal Reserve's (Fed's) 2% target. Despite this, as the Fed concluded its March meeting, it left monetary policy unchanged but continued to signal its intent to cut rates later in the year. In this week's Sight|Lines, we unpack the results of this Fed meeting and assess the risk that the Fed may not be able to cut rates later this year if inflation remains elevated.

THE TAKEAWAY: THE FED WAITS FOR ITS EXPECTED COOLER INFLATION

Recent reports show inflation is firm, and the Fed kept policy unchanged in March. In summary:

- Both the February Consumer Price Index (CPI) and Producer Price Index (PPI) reports show inflation as still elevated above the Fed's 2% target.
- But the Fed kept its policy rate unchanged in March, with little change to its statement.
- The Fed released its updated Summary of Economic Projections (SEP), providing insight on the range of views of the members of the Federal Open Market Committee (FOMC).
- The median expectation is for three quarter-point cuts in the Fed funds rate later this year.
- This corresponds to the view that our economy will do better in 2024 and improves on what was already a positive outlook published in December.
- Importantly, the Fed expects inflation to cool toward the 2% target, but the median projections indicate inflation is expected to remain above target until 2026.
- In his post-meeting press conference, Chairman Jerome Powell signaled optimism that inflation is header lower, but expects the path to be "bumpy."
- Markets have reacted positively, and market participants' Fed rate views better align with the Fed's outlook.

IN-DEPTH: IN MARCH, THE FED KEPT MONETARY POLICY UNCHANGED, AWAITING COOLER INFLATION, WHICH IT EXPECTS LATER IN THE YEAR, SO IT CAN THEN CUT RATES

Despite firmer inflation, a constructive Fed kept policy unchanged and signaled cuts later this year. Going deeper:

- Exhibit 1 shows monthly inflation moved above 0.17%, the monthly equivalent of the Fed's 2% target:

    - For the three months ended February, monthly CPI averaged 0.33%, and PPI averaged 0.27%.
- The Fed left policy unchanged in March, with the only statement revision that job gains remained strong.
- The Fed's SEP provides helpful insight into the range of individual views:
    - The SEP analyzes the individual projections of the FOMC, both voting and non-voting.
    - The median expectations for the funds rate reflect three quarter-point cuts in the Fed funds rate later this year, while two members expect rates to remain unchanged this year.
- This corresponds to the view that our economy will do better in 2024:
    - The median projection shows a GDP growth rate of 2.1%, above the 1.4% December SEP median.
- Notably, the Fed expects inflation to cool toward the 2% target, but at modestly higher levels:
    - The median PCE Inflation projection is 2.4% for 2024, 2.2% for 2025, and finally 2% for 2026.
- In his post-meeting press conference, Chairman Jerome Powell signaled optimism, saying:
    - "The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2%."
    - "Inflation [is] coming down gradually toward 2% on a sometimes bumpy path."
- Markets responded positively as the meeting concluded, and market views of the Fed rate have evolved:
    - Exhibit 2 shows the Fed median forecast for the year-end Funds rate has remained steady, reflecting the three cuts this year.
    - The second line, representing the "market view" embedded in fed futures contracts, shows that for quite some time, market participants have expected more cuts this year, only coming into alignment with the Fed's median projection in the wake of the recent firmer inflation report.

CONCLUSION

While inflation remains firm, the Fed left its monetary policy unchanged at its March meeting. As expected, the Fed also released its SEP report, which shares insights on the projections of each individual FOMC member. We learned most members still expect inflation to cool well toward the 2% target, and, as a result, the median projection is for rate cuts later in the year. Markets reflect optimism in this improving monetary policy path. But by conditioning the rate cuts with sustained, improved inflation, we must be mindful that the Fed may be "painting itself into a corner" to keep rates elevated if inflation doesn't cool as expected.

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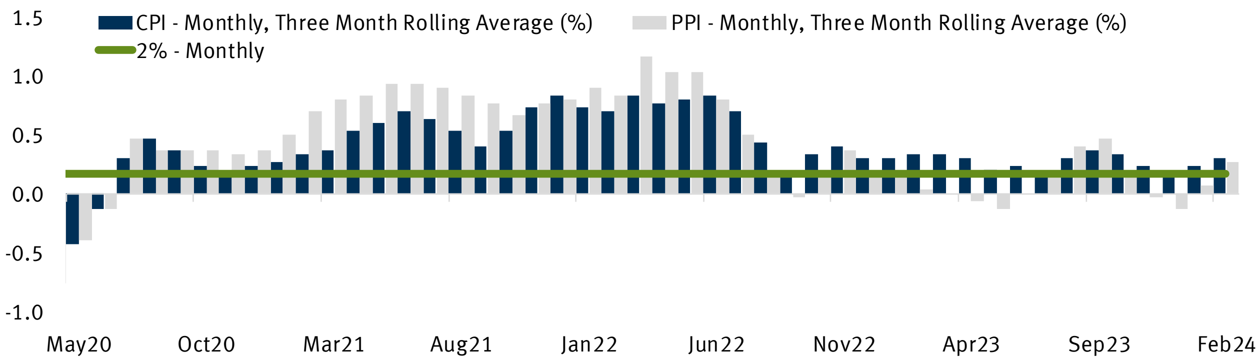
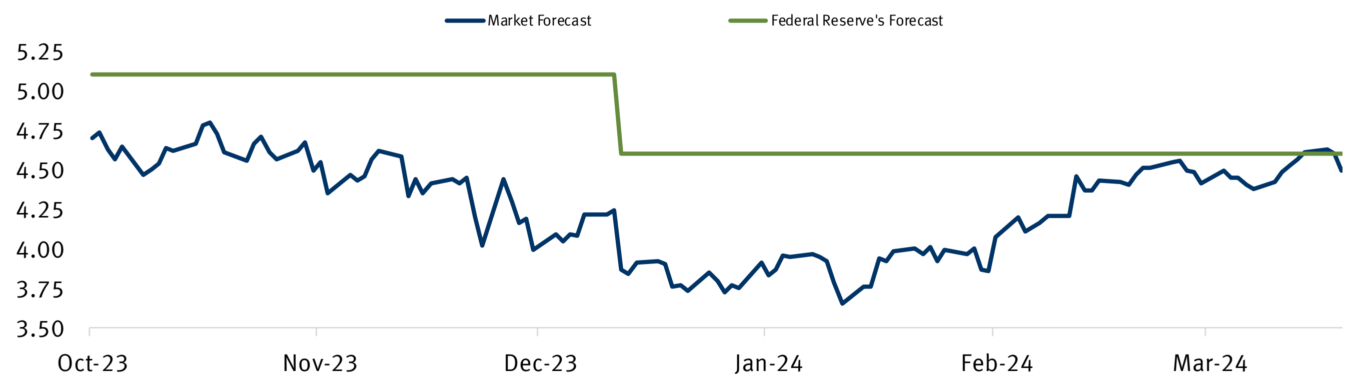
Exhibit 1. CPI & PPI Monthly and Three Month Rolling Averages



Source: Stifel CIO Office via Bloomberg, as of March 21, 2024

Exhibit 2: 2024 Interest Rate Forecasts



Source: Stifel CIO Office via Federal Reserve and Bloomberg data, as of March 21, 2024