Economic INSIGHT

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An Overly Optimistic Outlook for Growth and Inflation as the Fed Continues to Hike

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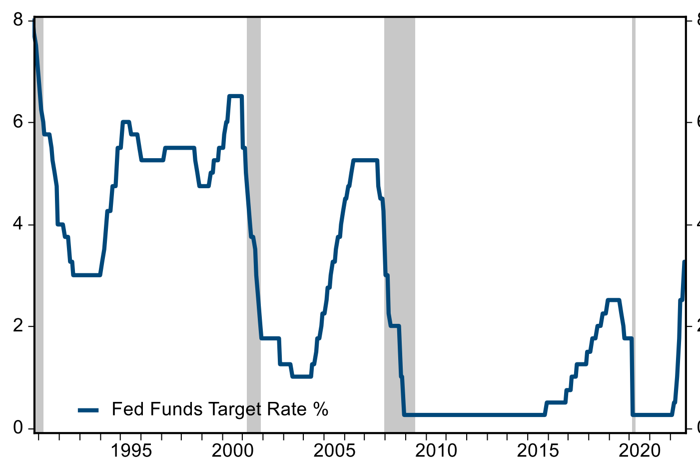
Last week, the Federal Reserve increased rates for the fifth time this year and warned more rate increases are likely. With inflation still stubbornly elevated, the Committee's updated policy outlook indicates the possibility of 100 basis points (bps) or more in additional rate hikes by the end of the year. But while Federal Reserve Chairman Jerome Powell underscored signs of weakness already evident in the economy and the pain higher borrowing costs will cause households and businesses, the Committee's forecast for both growth and labor market conditions remains surprisingly optimistic. From those opposing perspectives, we can infer the Fed is either overstating the need for further rate hikes to quell inflation, or it is underestimating the hardship additional increases will have.

POLICY DECISION



Source: Federal Reserve Board/Haver Analytics

Last week, as expected, the Federal Reserve issued its third consecutive 75bp increase, taking the Federal funds target range to 3.00% to 3.25%, and totaling 300bps in policy adjustments since March of this year. The September statement was also in line with expectations with the Committee reiterating its focus on inflation as prices remain still too high, warranting additional policy adjustments going forward. The Committee is "*highly attentive*" to the lingering risks of inflation, according to the statement.

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With inflation well above the Fed's preferred target range of 2%, the Committee not only chose to raise rates this month, but also anticipates "*ongoing increase in the target range*" will likely be "*appropriate.*"

Along with the latest policy decision, officials also updated their forecast, pointing to a much steeper pathway for rates. Along with more persistent inflation, the latest outlook also predicted a relatively more pronounced level of unemployment and more benign growth.

According to the last quarter's Summary of Economic Projections, the Fed was optimistic inflation would retreat markedly in the coming 12-18 months with modest but positive growth in both 2022 and 2023. The Committee additionally anticipated a terminal rate of 3.4% this year and 3.8% sometime in 2023.

	June SEP			September SEP	
	2022	2023		2022	2023
FF Rate:	3.4%	3.8%	FF Rate:	4.4%	4.6%
GDP:	1.7%	1.7%	GDP:	0.2%	1.2%
PCE:	5.2%	2.6%	PCE:	5.4%	2.8%
U6 Rate:	3.7%	3.9%	U6 Rate:	3.8%	4.4%

Source: Federal Reserve

In the latest September version, however, Fed officials indicated a potential need to push rates markedly higher than previously anticipated with the benchmark rate rising to 4.4% by the end of the year – a 100bp increase from earlier predictions – and further to 4.6% in 2023 before easing to 3.9% in 2024.

Coupled with a more aggressive pathway to higher rates, the Fed also underscored the more persistent nature of inflation and the likely more pronounced negative impact taming inflation will have on the domestic economy. According to the September SEP, forecasts for 2022 growth were reduced from 1.7% to 0.2% in 2022 and from 1.7% to 1.2% in 2023, with inflation expectations revised higher from 5.2% to 5.4% this year and from 2.6% to 2.8% next year. The updated forecast also shows a more precipitous rise in the unemployment rate to 4.4% by the end of next year versus a previous estimate of 3.9%, again a reflection of the more intensely negative impact anticipated from a more accelerated pathway to higher rates.

THE IMPACT OF HIGHER RATES – A REALISTIC FORECAST?

While the decision to hike rates this month was unanimous, and members agree it certainly won't be the last increase in the cycle, there remains some ongoing and increasingly fruitful discussion as to the size of additional rate hikes in the remainder of the year. After all, nine members anticipate an additional 125bps in tightening in the final two meetings of 2022, including a potential for a fourth-round 75bp increase on November 2, followed by an additional 50bps in December. Of course, as Powell noted in his press conference remarks, just as many officials judged – only – 100bps or less of

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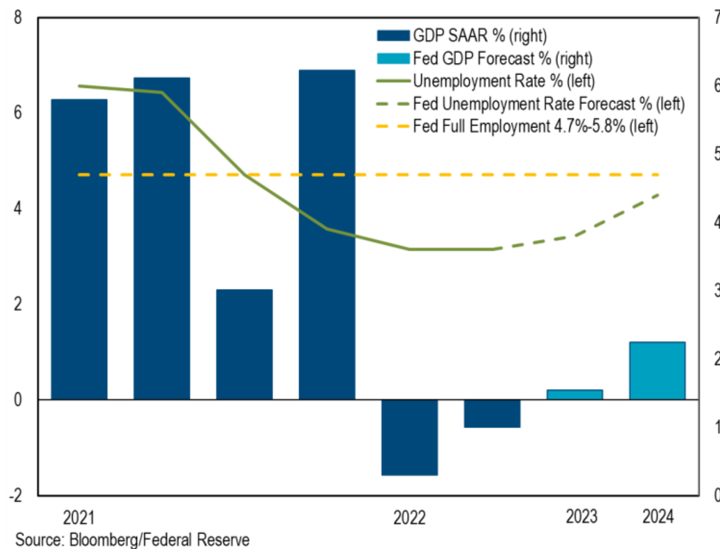
additional tightening may be more appropriate, suggesting a relatively more benign pathway of back-to-back 50bp increases in November and December.

Of course, with inflation still more than three times the Committee's desired 2% target, and 300bps of policy adjustments already implemented, a 25bp differential is arguably splitting hairs. Rather, investors should be questioning if even a rise to 4.4% by the end of the year, the highest level since 2007, or higher still to the Fed's new projected terminal rate of 4.6% next year will be enough to reinstate price stability. And, at the same time, is it realistic to assume an aggressive enough pathway to tame inflation will have a minimal cost of only 4.4% unemployment? Particularly given the nature of price pressures, the Fed's forecast for price growth to rapidly retreat by more than 3% in less than two years with only a modest impact on current conditions may be overly optimistic to say the least.

According to the S&P Case-Shiller 20 City Home Price Index, prices rose to a peak of 21.2% in the largest 20 metropolitan areas and 20.6% nationally. By contrast, in 2013, the 20-city index far outpaced the national market by three percentage points with an even larger gap of more than five percentage points in 2010.

After all, given the nontraditional composition of inflation with a sizable portion of price distortions stemming from the supply side of the equation, arguably raising rates well beyond 4% may prove more than adequate to quell demand-side inflation, but do little to address further price pressures as a result of lingering COVID-19 policies or international conflict. Of course, such a forecast may be rooted in the hopes of organic improvement. After all, Powell appeared somewhat optimistic that supply-side pressures have and will continue to abate. "*Commodity prices look like they've peaked,*" he said, and with supply distortions easing, if sustained, this would be a "*good thing*" for the Fed's fight against inflation. An understatement to say the least, this ideal scenario, as Powell insinuates, remains largely outside of the Fed's control.



Source: Bloomberg/Federal Reserve

Similarly, aside from potentially underestimating the Committee's ability to rein in costs, the Fed may also be understating the potential impact on the domestic economy. With

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growth already trending negative since the start of the year and ample weakness evident across nearly every sector of the economy, raising rates higher –100bps or 125bps – will almost assuredly result in further weakness in the economy and a sizable rise in the unemployment rate. Yet, even after this week's increase, the Fed continues to anticipate growth trending *positive* and a jobless rate still well below the lower bound of the Fed's full-employment range. Powell has acknowledged that monetary policy comes with a sizable lag, suggesting the full – negative – effects of earlier policy decisions have not yet been felt, which will eventually warrant a pause in policy to allow the Committee time to assess a potentially more sizable downturn in activity.

OUTLOOK

While a renewed commitment to a steeper upward trajectory in rates serves to underscore the Committee's longer-run resolve to rein in price pressures, surging borrowing costs may result in improved, but still historically elevated costs well above market expectations while all but ensuring a recession or a significant downturn in activity. This is a significantly more negative outlook than that proposed in the Fed's updated forecast. During the press conference, Powell acknowledged the declining probability of a soft landing, describing the unlikely outcome as "*increasingly challenging*." Such a realization, however, appears at odds with a forecast of still-positive growth over the near to medium term and still-solid conditions in the labor market. In other words, there appears to be a fictional or "*fantasy*" component in the Fed's latest forecast, with Committee members presuming they can pull a rabbit out of a hat.

Going forward, it's clear there is still work to be done with inflation uncomfortably high. As Powell indicated, with policy only at the "*beginning of the tightening range*," there is "*quite a ways to go*" from here. The expected outcome of a steeper trajectory in borrowing costs and the likely real impact on the economy, however, may be uncomfortably removed from the Fed's updated outlook. Rather than recognizing the limited impact a further backup in rates will have on supply-side price pressures, the Fed may risk raising rates artificially higher than otherwise necessary in a failed attempt to draw down cost-push inflation and at the expense of a more severe downturn.

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