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INSIGHTS

TURNING OFF THE MONEY SPIGOT

At last week's FOMC meeting, the Federal Reserve did not make any significant changes to monetary policy, as expected. However, the Fed did take some big steps toward laying the groundwork for changes to policy it will make in the future.

When it comes to short-term interest rates, the "dot plot" from the Fed now shows seven policymakers in favor of at least one 25 basis point rate hike in 2022, up from only four policymakers back in March. While those seven are still a minority of Fed policymakers, that was not the case for the following year. For 2023, a majority of policymakers – thirteen of eighteen – think the Fed will raise interest rates versus only seven of eighteen back in March. Moreover, the "median dot" now suggests the Fed would raise rates twice (for a total of 50 bp) in 2023.

Additionally, according to Chairman Jerome Powell, the Fed is now officially "talking about talking" about tapering its balance sheet purchases. For the time being it will keep buying a total of $120 billion in Treasury and mortgage securities per month to support the financial system, and Powell made it clear at the press conference that the Fed will only start tapering after it provides notice "as far in advance as possible." Analysts believe that notice will be provided by this Fall, with tapering starting by the beginning of 2022, maybe sooner.

Forecast

These changes by the Fed, its willingness to signal some rate hikes in 2023 and to talk more openly about the possibility of tapering, are consistent with some changes to its economic forecast. The forecast shows upward revisions to its projections for both real economic growth and inflation for 2021. The Fed lifted its real GDP forecast for this year to 7.0% (previously 6.5%) and its PCE inflation forecast to 3.4% (previously 2.4%). Forecasts for other years were little changed.

Furthermore, the Fed made some changes that hinted at problems with all the money sloshing around in the financial system, including lifting the interest rate it pays banks on reserves to 0.15% (previously 0.10%). The Fed said the goal was to help it keep trading in the federal funds market near the Fed's target for short-term rates. However, analysts think the actual goal is to make it more attractive for banks to hold cash, given that, in the current environment, with massive liquidity swirling around the financial system, when banks hold more cash they have a greater risk of running afoul of regulatory guidelines.

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Another notable part of last week's Fed activity was that Chairman Powell raised the possibility of inflation outstripping the Fed's projections on multiple occasions, stressing that "higher and more persistent" inflation could coax the Fed into adjusting the stance of monetary policy.

It is important to keep the news in perspective. The Fed is not going to raise short-term interest rates in 2021 and the bar for doing so in 2022 is still very high. The Fed's actions last week telegraph to the market that the yield curve has two years of gradual adjustment to get short-term rates higher. Since the forecasts are two years out, there are no surprises which would otherwise lead to a quick, violent, and disruptive shift in rate expectations to price in the Fed's new stance (such as in 2013). It would not be surprising if slowly over time they start hiking their 2023 projections further to guide rates and expectations higher. The Fed is sending smoke signals to get the market to do their bidding for them – a very smart move.

The bottom line is that there are now some real live hawks in the nest at the Fed. They are very young, and it will be a long time before they get to spread their wings and fly. However, the fact that the hawks have hatched is good news in setting monetary policy on a path back to normal.

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