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INSIGHTS

A CLEARER PATH ON INTEREST RATES

The Federal Reserve, at its latest meeting, gave the clearest indication around the timeline of tapering their monthly quantitative easing (QE), as well as expectations for the start of interest rate hikes.

Chairman Jerome Powell suggested that the central bank would announce at their November meeting that they would start dialing back their monthly purchases of $80 billion of Treasury bonds and $40 billion of mortgage-backed securities (MBS). Analysts estimate that they will reduce purchases of Treasuries and MBS by $10 and $5 billion respectively each month. This means that the Fed will have withdrawn all stimulus support after eight months – around mid-2022.

Rate Hikes and Inflation Outlook

In terms of rate hikes, there were some significant changes to the “dot plots,” which anonymously set out Fed policymakers’ projections for short-term interest rates over the next few years.

> The “dot plot” shows projections for the federal funds rate, the key short-term interest rate that can affect savings yields and consumer loan rates. Each dot represents the view of a Fed policy maker for the rate’s target range at the end of each year. Markets generally focus on the median “dot” or projection.

As in June, no-one at the Fed expects a rate hike this year. However, for 2022, the Fed is now evenly split, with nine policymakers projecting zero rate hikes while nine forecast at least one hike. That said, with tapering likely to continue until mid-2022, that would leave only four months or so before the mid-term election. Analysts do not believe the Fed will raise rates during that period.

Furthermore, the dot plots have indicated a more aggressive hike pattern for 2023, with the median short-term target at 1.0% for the end of 2023 (versus a prior estimate of 0.625%). For 2024, the median policymaker anticipates ending the year with a short-term target of 1.75%.

With respect to inflation, the Fed raised the inflation forecast for this year (4.2% versus a prior estimate of 3.4%), but with almost no change to inflation forecasts for 2022-23.

Despite the Federal Reserve technically bringing rate hike expectations forward to late 2022, the market reaction to these developments was positive. This positive reaction can be chalked up to two factors. First, there is more certainty around the taper, relieving any fears that the Fed might overstimulate the economy, which would run the risk of potentially further fanning inflationary flames. Second, by raising its inflation forecasts and bringing forward the potential for rate hikes, the Fed has demonstrated that it is intent on keeping inflation under control.

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Dual Mandate

Recall that the Federal Reserve has a dual mandate – price stability and maximum sustainable employment. The Fed has acknowledged that its objective of restoring employment to maximum sustainable levels is on track, which will allow it to focus its efforts on combating inflation and stabilizing prices. Some may argue that the Fed should've acted much sooner to remove the stimulus, but the fact that they have defined their exit strategy should give investors confidence that the central bank is watching developments closely. Though they may be erring on the side of caution, they are not paralyzed by uncertainty.

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