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GLOBAL ECONOMICS

SCOTIA FLASH

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Did Markets Hear Only What They Wanted to Hear from the Federal Reserve?

- **The Fed hiked by 75bps as expected…**
- **…continued to indicate that more hikes are ahead…**
- **…and delivered a statement that offered very few changes that markets ignored**
- **Markets nevertheless reacted dovishly to the press conference…**
- **…and for potentially dubious reasons…**
- **…within the mixture of what markets chose to emphasize and ignore**
- **Despite Powell's guidance, markets are pricing 50bps less than the dot plot's path**

The FOMC broadly met expectations with a see-ya-in-September feel to the overall set of communications. Markets initially shook off the statement itself. Treasury yields began to rally, the dollar began to weaken and the S&P500 began to rally about ten minutes into the press conference for somewhat dubious reasons that are cited below.

MARKETS INITIALLY YAWNED

The statement itself offered no real surprises. They hiked 75bps as broadly anticipated which set the upper bound of the Fed funds target range at 2.5% for 225bps of cumulative rate hikes so far this year. They also repeated the same forward guidance by saying "ongoing increases in the target range will be appropriate" that indicates they remain on an unchanged hike path. Other statement changes were minor.

- The opening line did what was widely expected by downgrading reference to the economy's recent performance. Instead of saying activity picked up after edging down in the first quarter, they now say "recent indicators of spending and production have softened" while retaining unchanged reference to job market strengths.
- the statement deleted reference to China's COVID-related lockdowns and how they could worsen supply chain disruptions.
- There were no dissenters this time compared to the prior statement when KC Fed President George dissented in favour of a 50bps hike instead of 75.

MARKETS REACTED TO THE PRESS CONFERENCE

It was during the press conference when some things Powell said prompted more of a market reaction.

- For one, he said that while they wouldn't hesitate to make an even larger move than they made today if they judged that doing so would be appropriate, "that was not the case today." He didn't elaborate which suggested that a move bigger than 75bps wasn't given serious consideration. Markets should've largely known that in advance at least based upon what some Fed officials had been saying of late. Regardless, that may have been taken by markets to set a very high bar to a bigger than 75 move and rein in some of the fear factor.
- Powell broadly validated the June dot plot and overall Summary of Economic Projections. He bluntly stated "I think you can think of the destination as still broadly in line with the June SEP." In other words, that the Committee is still leaning toward an upper bound for the Fed funds target range of 3¼ – 3½% toward the end of 2022 and 3.75% next year. That may have been taken by markets to lessen the odds of moving even higher, at least for now.

- Powell indicated that there is heightened sensitivity to near-term data when he said "over the coming months we will be looking for compelling evidence that inflation is turning down" and that ongoing rate increases will be appropriate. Markets may have taken that as an approaching limit to the cumulative hikes.
- Powell also said that "as the stance of policy becomes tighter it will likely become appropriate to slow the pace" of rate increases. I think that's a truism in that if you're already at 2½% and still validating a 3¾% peak then yes clearly at some point it becomes appropriate to slow hikes. That shouldn't have been unexpected or surprising, but maybe it was to markets.
- Powell noted that "The Committee broadly feels that we need to get policy to at least a moderately restrictive level. That is 3.25–3.5% by year-end and another 25bps next year. We'll update that in the September meeting. We think it's appropriate to shift to a meeting-by-meeting basis and not provide the clear guidance we've previously provided." Markets may have interpreted this comment in a similar manner to the way they took the prior point. Still, as the Fed gets within reach of restrictive territory it should be expected that they would become increasingly data sensitive as argued.
- Powell didn't reject market pricing for rate cuts next year, but also didn't validate it. Markets might have only heard him fail to reject it. When asked about this he simply said "It's very hard to say even in normal times where we'll be in 6–12 months let alone now. There is more uncertainty now. The only data point I have for you right now is the June SEP. Since then, inflation has come in higher and activity weaker than expected. Still, those projections saw a move to a moderately restrictive stance that we'll update at the September meeting."

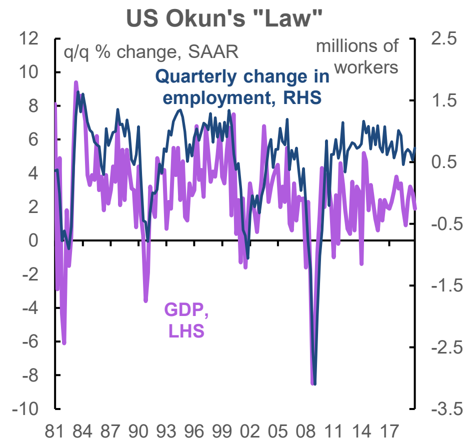
WHAT MARKETS MAY NOT HAVE HEARD

Now against much of that is evidence that markets may have either chosen not to hear or downplayed. In my view, the broad market reaction to the communications ignored the following points. The proof lies in the evidence that markets are now pricing a peak policy rate that is 50bps lower than the SEP that Powell said is still valid which suggests markets aren't listening to the full set of communications.

- When asked about whether he has changed his view on the terminal rate since June, Powell observed that the latest inflation reading was even worse than was expected but that "By the time of the September meeting we will have seen two more inflation and job readings plus geopolitical developments. We'll make our decision at that meeting." That may indicate that if forced to decide now then he'd lean toward more hikes, but he wants more data and has the luxury of taking his time to get it until the next meeting.
- Powell said that "while another unusually large increase could be appropriate at the next meeting, that is dependent upon the data between now and then." The September OIS pricing moved a few basis points lower toward pricing just under a 50bps move and is therefore clearly not positioned for the risk of another 75 move.
- Powell said that "underlying aggregate demand remains solid" and that "supply constraints have been larger and longer lasting than expected." That indicates he doesn't think there has been enough progress toward bringing supply and demand more into balance and hence less inflationary.
- Powell generally downplayed declines in "some" prices. That might surprise some folks who argue inflation risk is peaking, even though month-over-month core CPI just hit its hottest rate in a year and pending PCE figures.
- Powell was incrementally more candid in referencing how some damage is to be expected from shaking his hips in a China shop. He said "This process is likely to result in below-trend economic growth and some softening in labour markets" which is "necessary." He also said "We think it's necessary to have growth slow down. We think there will be a period of growth lower than potential and some softening of labour market conditions." That indicated that weakening activity won't get in the way of efforts to cool inflation.
- When asked whether he thinks the risks of doing too little outweigh the risks of doing too much and whether he'd prefer to make the mistake of doing too much than too little, Powell repeated that "the path to a soft landing has narrowed" and that "Restoring price stability is something that we have to do." He also said "We're trying not to make a mistake. The risk of doing too little and leaving entrenched inflation raises the cost of dealing with it later when expectations and behaviour take over. It's important we address this now." This indicates an ongoing bias toward 'front-loading' hikes by whatever it takes to stand a chance at cooling inflation regardless of the implications to the economy.
- I thought Powell's comments on GDP were interesting. He said "You pretty clearly do see a slowing in demand in Q2. People widely looked at the Q1 numbers and thought they didn't make sense. That's not true of the second quarter and yet the labour market is

strong. There have been many such times like this and the economy rebounded. Sometimes there is residual seasonality. We do think demand is moderating but we're not sure. We do want to see demand growing below potential for a sustained period." I'm flagging this because it indicates that if the Fed doesn't see demand sustainably moderating over 2022H2 then this may lessen their faith in the view that inflation will cool which could drive incremental hawkishness.

Chart 1



Sources: Scotiabank Economics, BLS, BEA.

OTHER INSIGHTS

Balance Sheet Plans

When asked about balance sheet plans Powell simply said that the planned reduction of the size of the balance sheet is working and that "Markets should be able to absorb this. The plan is broadly on track. The process of getting back to a new equilibrium for reserves could take 2–2.5 years according to our model." That's broadly consistent with Scotia's expectation that roll-off of maturing Treasuries and MBS won't begin to be tapered until early 2024 and roll-off won't end until around mid-2024 with the ultimate size of the SOMA portfolio resting at just over US$6.5 trillion by then (from US$8.37 trillion now).

GDP Versus Employment

Powell intimated that he thinks GDP growth data may be low and subject to upward revision by referencing how the labour market is so strong that it leads one to question the GDP data. That's putting a lot of stock in Okun's 'law.' Far too much. GDP growth and employment growth moved reasonably in tandem with one another until about the GFC but since then the relationship has been pretty weak in that job growth has been stronger than GDP growth for an extended period of time compared to the historical relationship (chart 1). I find it bothersome that there is such a willingness to reject GDP data through various forms of casual empiricism in the Fed's upper ranks including what I wrote on the GDI-GDP debate the other day (**here**).

Please also see the attached statement comparison including highlights of what changed.

RELEASE DATE: July 27, 2022

Recent indicators of spending and production have softened. Nonetheless, job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher food and energy prices, and broader price pressures.

Russia's war against Ukraine is causing tremendous human and economic hardship. The war and related events are creating additional upward pressure on inflation and are weighing on global economic activity. The Committee is highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 2-1/4 to 2-1/2 percent and anticipates that ongoing increases in the target range will be appropriate. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet that were issued in May. The Committee is strongly committed to returning inflation to its 2 percent objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michael S. Barr; Michelle W. Bowman; Lael Brainard; James Bullard; Susan M. Collins; Lisa D. Cook; Esther L. George; Philip N. Jefferson; Loretta J. Mester; and Christopher J. Waller.

RELEASE DATE: June 15, 2022

Overall economic activity appears to have picked up after edging down in the first quarter. Job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher energy prices, and broader price pressures.

The invasion of Ukraine by Russia is causing tremendous human and economic hardship. The invasion and related events are creating additional upward pressure on inflation and are weighing on global economic activity. ***In addition, COVID-related lockdowns in China are likely to exacerbate supply chain disruptions.*** The Committee is highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 1-1/2 to 1-3/4 percent and anticipates that ongoing increases in the target range will be appropriate. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet that were issued in May. The Committee is strongly committed to returning inflation to its 2 percent objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; James Bullard; Lisa D. Cook; Patrick Harker; Philip N. Jefferson; Loretta J. Mester; and Christopher J. Waller. ***Voting against this action was Esther L. George,*** who preferred at this meeting to raise the target range for the federal funds rate by 0.5 percentage point to 1-1/4 percent to 1-1/2 percent. Patrick Harker voted as an alternate member at this meeting.