Scotiabank

GLOBAL ECONOMICS

SCOTIA FLASH

September 20, 2023

Contributors

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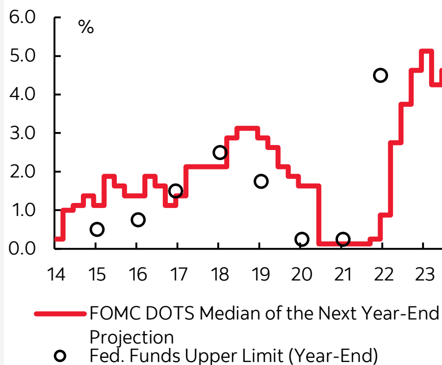
Chart 2



Sources: Scotiabank Economics, Bloomberg.

FOMC Forecasts Higher For Longer Rates

- **The FOMC held the fed funds target range unchanged as widely expected**
- **Dots show another hike this year, fewer cuts next year as expected**
- **Forecasts marked up GDP growth, lowered the UR and tweaked core PCE**
- **There is a very wide range of opinions on cumulative easing into 2025**
- **The neutral rate was left unchanged at 2.5%**
- **Spillovers include pricing toward two more 25bps BoC hikes**

The FOMC largely met expectations but apparently offered a mild surprise to some folks in the markets. The effects spilled over internationally such as pricing decent odds at two more 25bps hikes by the Bank of Canada and we'll likely see more reverberations into the overnight session. Please see the accompanying statement comparison as well as the full Summary of Economic Projections **here**.

The US 2-year Treasury yield climbed by about 11bps to 5.16% into the close, the USD firmed by about 0.3% on a DXY basis with USDCAD rising by about half a penny, and the S&P500 fell by over 1% into the close. Markets slightly raised pricing for a further hike before year-end with a little over half of a 25bps move priced in.

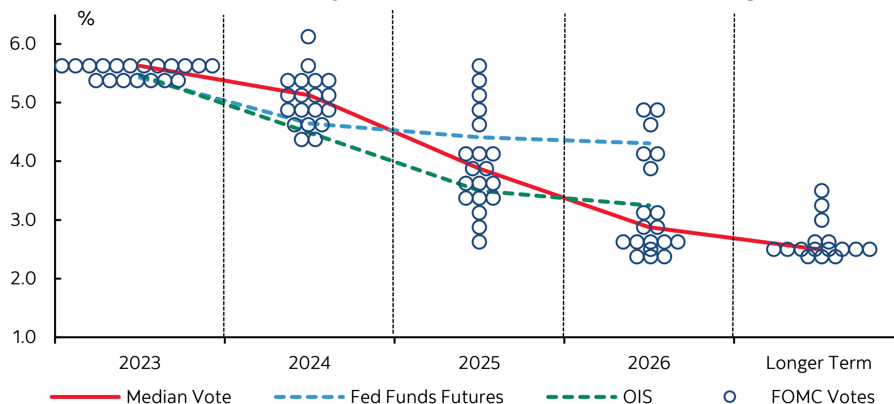
The biggest move was about a 20bps increase in pricing for where the fed funds target rate is expected to end 2024 in a higher-for-longer sense. I wouldn't be surprised to see that being faded when markets come to their senses on the usefulness of the dot plot.

Overall there were minor statement tweaks that were accompanied by unchanged forward guidance for another hike to come this year while reducing cuts in half to -50bps next year. Forecast changes were largely as expected.

Chair Powell emphasized that they are essentially in a data dependent holding pattern at the moment by saying:

> "Given how far we have come we are in a position to carefully assess the appropriate stance" which isn't really new compared to earlier pause logic that they don't have to go in a straight line at the fine tuning stages.
>
> and "Holding at this meeting does not mean we think we have reached the peak. A majority of participants believe it will be appropriate to raise one more time at one of this year's two remaining meetings."

Chart 1



Note: OIS & Fed Fund Futures as of Sep 20, 2023.
Sources: Scotiabank Economics, US Federal Reserve.

FEW STATEMENT CHANGES

There were very few statement changes. Wording upgraded the assessment of growth from “moderate” to “solid.”

Instead of saying job gains “have been robust in recent months” they acknowledge cooler gains by saying they “have slowed in recent months but remain strong.”

The third paragraph was left intact and therefore they retained guidance to be data dependent in “determining the extent of additional policy firming that may be appropriate.”

THE DOT PLOT SIGNALS HIGHER FOR LONGER

Chart 1 shows the new dot plot including relative to market pricing. The FOMC retained guidance that the fed funds target rate will have to increase by another 25bps to 5.75% at one of the two remaining meetings this year by a 12–7 margin. That’s significant because it reflects a decent majority and not just one or two swing voters.

Next year’s projection cut in half projected easing to 50bps from 100bps previously. The upper limit ends 2024 at 5.25%.

The amount of cutting in 2025 was left unchanged at 125bps but because of fewer cuts in 2024 than previously the level of the fed funds target rate by the end of 2025 was raised 50bps to an upper limit of 4%.

The addition of 2026 sees the upper limit ending that year at 3%.

The longer-run neutral rate was left unchanged at 2.5%.

WHY HIGHER FOR LONGER?

Chair Powell further elaborated upon the reasoning and cautions behind projecting a higher for longer policy rate during his press conference.

When grilled on what the Committee is seeking to communicate by raising the projected real rate and whether it means they think they have to do more to achieve basically the same inflation they had projected in June, Chair Powell said that “Reduced easing is more about stronger economic activity which means we have to do more with rates.”

Later on he correctly noted that “GDP is not a mandate. Maximum employment and price stability are the mandates. Is the heat in GDP really a threat to getting back to 2% inflation? That is the question.”

To which one could somewhat rhetorically ask how much confidence does he have using projected GDP growth as a guide to today’s complex inflation drivers given that so much of the inflation we have seen has not been well explained out of sample by traditional Phillips curve models.

Powell also noted that “Confidence comes from seeing enough data and then we'll decide for how long we'll stay there. We haven't gotten to a point of confidence about whether we are restrictive enough.”

Still, when asked to explain the range of views around whether to hike again he said:

“What people are saying is let's see what the data shows. We want to see that cooler inflation is about more than just three months. We want to see further rebalancing of the labour market. People want to be convinced and be careful not to be convinced to jump to one conclusion or the other. Given how far we have come we are in a position to proceed carefully, meeting by meeting.”

SO WHAT

As a reminder, the dots are not terribly useful outside of the current year. They are to be quickly faded by market participants as no better than their own guesses. This is shown in chart 2. What the FOMC shows is one part indicative of what they may think will happen, and one part dirtied by a market management objective.

FORECAST CHANGES

Please see charts 3–6 for comparisons of the Committee’s projections at this meeting versus the June meeting and relative to Scotiabank Economics’ current projections.

Chart 3

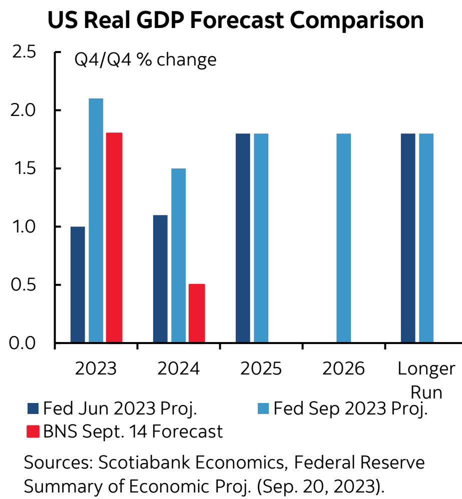


Chart 4

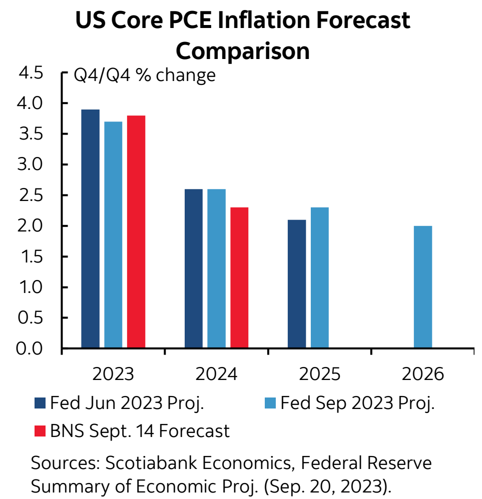


Chart 5

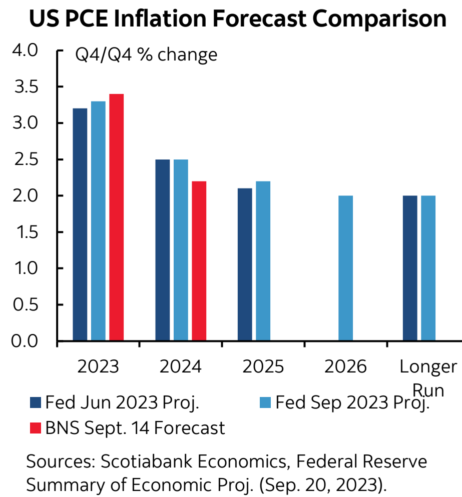
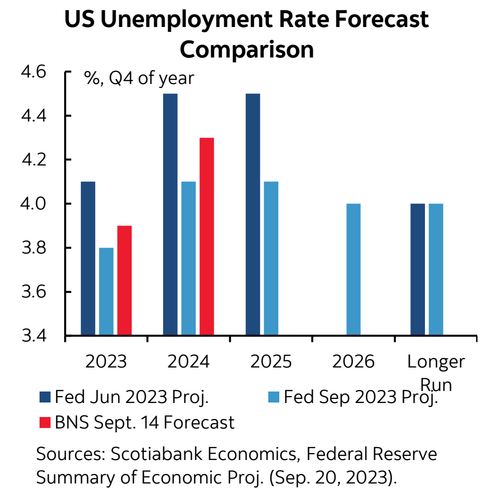


Chart 6



The Committee upgraded 2023 GDP growth to 2.1% q4/q4 from 1% which is marking to market for the most part in light of persistently stronger growth than forecast. Next year is also upgraded a bit to 1.5% from 1.1% and then 1.8% is unchanged for 2025 and extended throughout.

They lowered the projected unemployment rate by Q4 of each year to 3.8% in 2023 which is mostly just about marking to wat has happened. They lowered next year's projected unemployment rate to 4.1% from 4.5% and carried that into 2025 while leaving the longer run natural rate at 4%

There were only minor tweaks to core PCE. They now project core PCE to be up by 3.7% q4/q4 in 2023 from 3.9% previously, left next year unchanged at 2.6%, and revised up a tick to 2.3% in 2025 and then magically on target at 2% in 2026.

CANADIAN SPILLOVER

Canada followed the US moves in sympathy. Canada's two-year yield moved 7bps higher after the FOMC communications. The Canada 10-year yield moved 6bps higher. The C$ depreciated by about 0.6 cents to the USD. The TSX fell by about ½%.

This is all because markets are now pricing a full 25bps rate hike by the Bank of Canada by the December/January meeting and part of another by March. I think that's sensible for now while retaining high optionality around the individual meeting moves. If the Fed hikes then it raises the odds of another BoC hike and then layer on the idiosyncratic elements to the Canada story that have AT LEAST one more hike in the cards and very possibly more as I have been arguing for some time now. The 2-year yield has cheapened by about 35bps so far this month in keeping with my marketing to clients that argued it was still priced too dearly.

CONCLUSION

So now the debating kicks into higher gear as the data rolls in. The Committee showed another hike partly because they know what has happened in past soft patches and partly to avoid signalling confidence they are done at this meeting and wish to control markets. Whether it gets delivered or not (fairly high probability) will come down to the data. And fade next year's and subsequent dots as an exercise in futility.

RELEASE DATE: September 20, 2023

Recent indicators suggest that economic activity has been expanding at a solid pace. Job gains have slowed in recent months but remain strong, and the unemployment rate has remained low. Inflation remains elevated.

The U.S. banking system is sound and resilient. Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains 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 **maintain** the target range for the federal funds rate **at 5-1/4 to 5-1/2 percent**. The Committee will continue to assess additional information and its implications for monetary policy. In determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in its previously announced plans. 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 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; Lisa D. Cook; Austan D. Goolsbee; Patrick Harker; Philip N. Jefferson; Neel Kashkari; ***Adriana D. Kugler***; Lorie K. Logan; and Christopher J. Waller.

RELEASE DATE: July 26, 2023

Recent indicators suggest that economic activity has been expanding at a moderate pace. Job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated.

The U.S. banking system is sound and resilient. Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains 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 5-1/4 to 5-1/2 percent**. The Committee will continue to assess additional information and its implications for monetary policy. In determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in its previously announced plans. The Committee is strongly committed to returning inflation to its 2 percent objective.

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