First Trust
ECONOMIC RESEARCH REPORT
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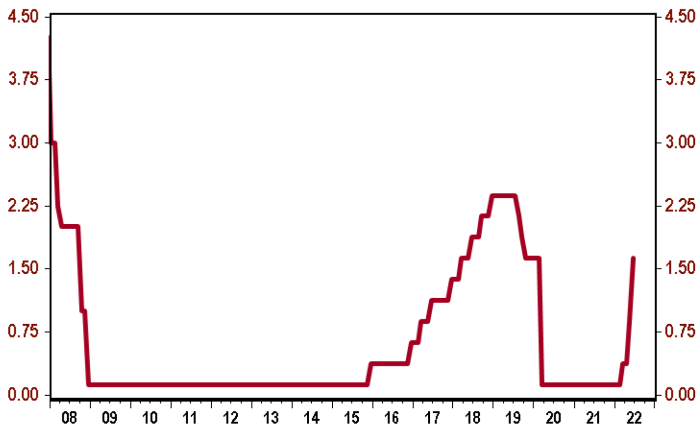
Fed Goes Bigger

The Federal Reserve raised rates by three-quarters of a percentage point (75 basis points) today, the most at any meeting since 1994 and exactly the move Chairman Jerome Powell was dismissive about in early May after the last meeting. As a result, the target for the federal funds rate is now 1.50 – 1.75%, and it's headed higher. At the post-meeting press conference, Powell made it clear that the Fed doesn't expect 75 bp rate hikes to become "common," but a rate hike in the 50 – 75 bp range should be expected at the next meeting in July.

The "dot plot" from the Fed, which is released every three months and which shows the path monetary policymakers expect the funds rate to take, shows a much steeper pace of rate hikes than the dot plot released back in March. Earlier this year, the dot plot suggested the funds rate would finish 2022 around 1.875%; now the Fed suggests it will finish around 3.375%. That's an additional 150 bps. Perhaps more important: every single Fed policymaker thinks the funds rate will finish this year above 3.00%. For 2023, the median policymaker projects the funds rate will finish at 3.625%, before gradually starting to decline in 2024 and beyond.



Notably, the Fed downgraded its real GDP growth forecast for this year to 1.7% versus a prior estimate of 2.8%. Growth in 2023-24 was revised down slightly. Meanwhile, the Fed increased its estimate for PCE inflation this year, to 5.2% from 4.3%, but slightly revised down its forecast for inflation in 2023-24. We believe the Fed's inflation forecasts for 2023 and 2024, 2.6% and 2.2%, respectively, are ridiculously low. On net, the Fed downgraded its expectations for nominal GDP growth (real GDP growth plus inflation), which is hard to square with increasing the path for short-term interest rates unless it's seen as a major admission of past policy mistakes and that the Fed knows it is well behind the inflation curve.

Also of note: the Fed removed language from its last statement in May that it expects the "labor market to remain strong." This is consistent with the new Fed economic projections, which shows that the unemployment rate, now 3.6%, should finish the year at 3.7% and then go up 0.2 percentage points in each of the next two years. However, it could also be a hint that the Fed knows fighting inflation may eventually take a set of policies that generate a recession.

In our view, the next important date to watch for the Fed is not the next meeting in late July, it's June 28, when the Fed releases figures on the M2 measure of the money supply for May. M2 declined in April, but we think that may have been related to very high tax payments that month. Wrestling inflation back down will require a persistently slow pace of M2 growth for at least the next couple of years. With regard to quantitative tightening, the Fed will stick to its current schedule of reducing the balance sheet by $47.5 billion per month until September, when that pace will double.

There was one dissent at today's meeting, from Kansas City Bank President Esther George, who preferred an increase of 50 bps rather than 75 bps.

The bottom line is that it's good the Fed is now more aware of the enormity of the inflation problem it has created, although it is still too optimistic at how quickly it will get it back under control. It's now serious about raising rates. Another big step would be to start to release money supply figures on a weekly basis, like it used to, so everyone can see the progress it's making in closer to real time.

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Text of the Federal Reserve's Statement:

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.

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