First Trust
ECONOMIC RESEARCH REPORT
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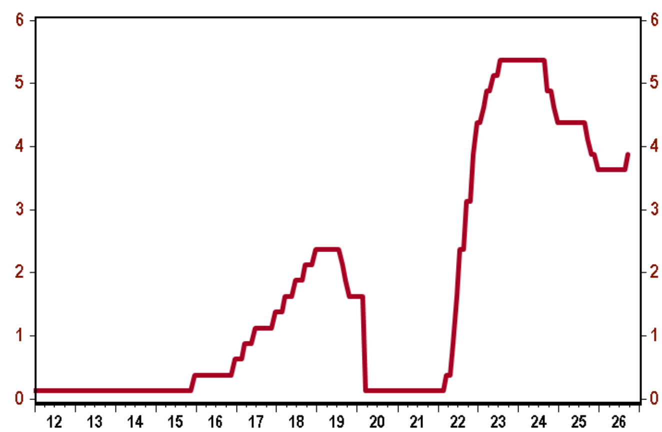
One Hike Today, Fed Signals More to Come

The Federal Reserve today unanimously decided to raise its short-term interest rate target by a quarter percentage point to a range of 3.75 – 4.00%, the first hike since mid-2023. The Fed made two key changes to the statement announcing its decision, declaring that "domestic spending has been resilient" and the rate hike "will support a timelier return" to the Fed's 2% inflation target.

In the press conference following the meeting, Chairman Warsh emphasized the strength of the US economy and the potential for an acceleration of that growth have shifted the Fed's focus to price stability and that inflation has been too high for too long.



Source: Federal Reserve Board/Haver Analytics

What's odd about the rate hike is that the Fed was making steady progress against inflation in the few years prior to the Iran War. The increase in inflation since then is due to a spike in energy prices. Going into this year the Fed's "playbook" based on prior economic research was that when inflation moves up temporarily due to a negative supply shock (which is what it is experiencing now in the energy sector) the Fed should hold monetary policy steady, neither tightening nor loosening, until the supply shock runs its course. Yet now the Fed is instead hiking rates into a negative supply shock, even though higher short-term rates will do nothing to boost energy supply.

On top of this, the "dot plot" released after today's Fed meeting suggests policymakers will raise rates one more time later this year, with two members signaling no more changes this year, twelve members projecting one more hike (of 25 bps), and four members forecasting two more hikes. We think one more hike is the most likely outcome, not only because of the dot plots but also because it is very unlikely the Fed will raise rates at the next meeting, which is within one week of the mid-term elections this November.

Beyond this year, the "median dots" show no rate hikes in 2027, and then one rate cut in each of 2028 and 2029. This is a less aggressive path for short-term rates than is now embedded in the futures market for federal funds, which suggests one more rate hike this year and then one or two more hikes in 2027.

In the meantime, the economic projections from the Fed were little changed versus the projections they issued in June, with only slightly faster economic growth and inflation. The most notable change in the projections from the Fed was perhaps the most subtle, which is that the Fed now anticipates that the long-run average federal funds rate will be 3.2% versus a prior 3.1%, which, if adjusted further upward in future meetings could signal that the Fed is rethinking the level of its ultimate destination for short-term rates once inflation does get to 2.0%.

It's also important to recognize that the US economy is significantly split right now between robust growth in the technology sector, which is more insulated from interest rate moves, and weakness in some other sectors like housing, which is rate-sensitive. As always, we think investors should be paying more attention to the moderately-growing M2 measure of the money supply, which is signaling that year-ago comparison measures of inflation will settle down toward 2.0% once we get more than a year past the early months of the oil price shock.

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Text of the Federal Reserve's Statement:

The Federal Open Market Committee approved the following statement for release by a 12 – 0 vote:

The Committee decided to raise the target range for the federal funds rate by 1/4 percentage point to 3-3/4 to 4 percent, in support of the Federal Reserve's dual mandate. The Committee is continuing its policy of maintaining ample reserves in the banking system.

Economic activity is expanding at a solid pace. While uncertainty remains elevated owing, in part, to geopolitical developments, domestic spending has been resilient. Productivity growth is strong, and capital investment is robust. Job gains have kept pace with the workforce, and the unemployment rate has changed little.

Inflation remains elevated. Today's policy action will support a timelier return to the Committee's 2 percent goal. The Committee will deliver price stability.