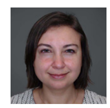
The Fed Embarks on a Hiking Campaign to Counter Inflation

High commodity prices, geopolitical risks complicate its path.

March 2022



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KEY INSIGHTS

- The Fed has begun normalization of monetary policy and signaled that this tightening cycle will be faster than the previous one following the global financial crisis.
- Its focus remains bringing down elevated inflation, which we believe it can only achieve by cooling down a hot labor market and tightening financial conditions.
- Fed policymakers will likely increase rates seven times in 2022, but tightening amid potential slowing of global growth raises recession risk.

Federal Reserve (Fed) policymakers raised rates 25 basis points (bp)[1] at the March Federal Open Market Committee (FOMC) meeting. It also signaled this is likely to be a much faster tightening cycle than the one after the global financial crisis. The Fed's focus remains bringing inflation down from a historically high level amid a strong labor market and solid consumer demand following the global pandemic. Since the central bank's hawkish pivot late last year, the jobs market and inflation have been stronger than expected, implying more urgency to act. We believe that inflation is unlikely to slow without decisive policy action, and FOMC participants have increasingly shifted to this view. For example, the median FOMC participant expected to increase interest rates seven times at the March meeting, compared with median expectations of only three hikes last December.

The hawkish pivot within the FOMC could intensify. For some time now, Chair Jerome Powell has not ruled out the possibility of hiking rates by 50bp instead of 25bp at an upcoming meeting during the course of this year should the need arise, that is, if inflation persists at a higher level than the current FOMC projections. The March dot plot, a graphical depiction the Fed uses to indicate its expectations for interest rates, revealed that seven FOMC participants expect more than seven hikes this year. This suggests broadening support for front-loading policy action and increases the chances of a 50bp hike in one of the upcoming meetings.

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[1] A basis point is 0.01 percentage points.

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Policymaker Projections Reflect Growing Uncertainty

The Summary of Economic Projections (SEP) showed that the Fed expects growth to be materially slower this year, likely reflecting the effect of monetary policy tightening as well as increased uncertainty about the U.S. economy as Russia's invasion of Ukraine roils commodities markets and further disrupts supply chains that were already under pressure from the pandemic.

At the same time, it revised significantly higher the inflation forecast while recognizing a broadening in price pressures beyond the pandemic-related disruptions. We think that this shift in its assessment of inflation dynamics is key in understanding the Fed's hawkish pivot and its resolution to tighten policy this year. Another key takeaway from the SEP is that the FOMC intends to shift the stance of monetary policy from accommodative to neutral and then to slightly restrictive before the end of next year, another sign that it intends to move at a fast pace.

The Fed's Difficult Balancing Act

Tighter monetary policy is needed, in our view, to counterbalance high realized inflation and a hot labor market. Global commodity prices have risen rapidly, and geopolitical tensions risk straining supply chains further. Both imply upside risks to the inflation outlook. The Russian-Ukraine war and the sanctions that followed have also weighed on financial conditions[2] and caused significant market volatility; as a result, they represent a new headwind to growth. Although the U.S. economy is better insulated from these risks than other developed markets, it cannot operate in a vacuum and will likely be affected in the event of slowing global demand, something that Powell recognized during the March FOMC press conference.

On balance, we think that the U.S. economy will likely face more significant upside risks to inflation than downside risks to growth this year. This would lead Fed policymakers to maintain a tightening bias and regular rate increases, barring a sharp drop in growth or inflation.

Baseline Scenario Is Orderly Exit From Accommodative Policy

Our baseline scenario is that the U.S. economy will likely have an orderly exit from the current accommodative policy stance, avoiding a recession. However, the Fed will have to be patient in bringing inflation down. In our view, 2.0% personal consumption expenditures (PCE) inflation—the Fed's formal target—will likely not be within reach until the end of 2023.

Two Potential Policy Risk Scenarios

We see two potential policy risk scenarios for the Fed. In the first, a soft economic landing eludes the central bank. Having waited to tighten until inflation was already high, the FOMC may have to increase interest rates at a faster pace than would be consistent with only a moderate slowing in demand and weakening of labor markets. Sluggish demand in Europe (and globally) amid the Russia-Ukraine war would exacerbate this risk.

In the second policy risk scenario, the hot labor market, strong consumer demand, and the multiple supply-side shocks that have all pushed inflation higher could cause an increase in inflation expectations. In fact, recent consumer survey data indicate that while long-run inflation expectations remain well anchored, short-term expectations have moved significantly higher. Without strong Fed policy tightening, longer-term inflation expectations could also increase, resulting in higher inflation becoming entrenched in the economy.

[2] Financial conditions are measured by Treasury yields, credit spreads, stock prices, and the price of the U.S. dollar. Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

WHAT WE'RE WATCHING NEXT

Inflation readings—both headline and core (excluding food and energy prices)—remain front and center in determining the likely path of Fed rate increases. We anticipate that inflation will peak in the first half of the year, but supply chain disruptions have already continued for longer than many originally expected.

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