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TRENDMACRO LIVE!

On the March FOMC

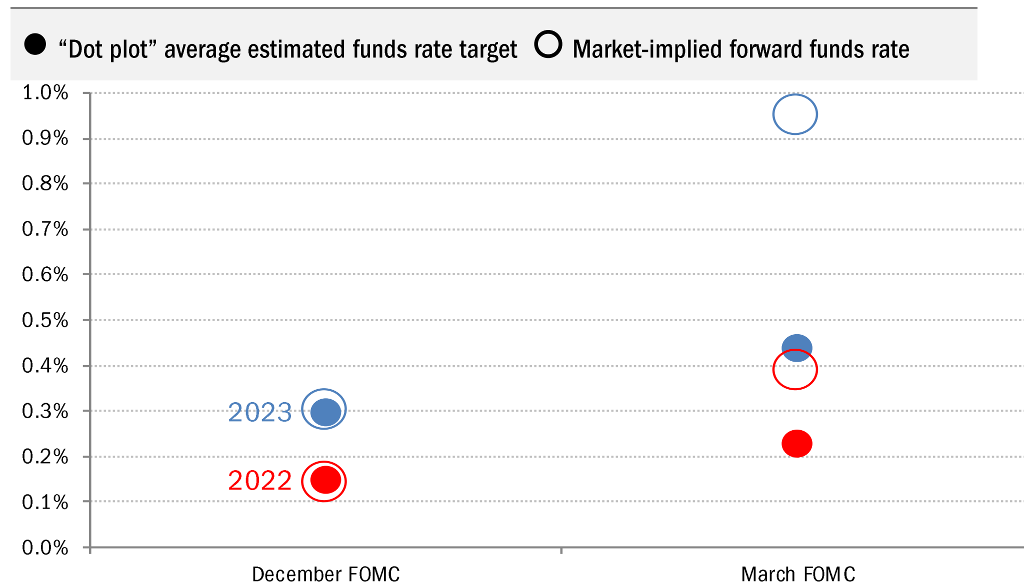
Wednesday, March 17, 2021

Donald Luskin

The Fed means it. Yes, inflation can rise above 2%. No, we won't tighten when it does.

Other than saying that economic indicators have "turned up recently," it's no surprise that there were literally no changes in today's FOMC statement (for a complete red-line mark-up, such as it is, see "Data Insights: Federal Reserve" March 17, 2021). And we knew chair Jerome Powell wouldn't say anything in the post-meeting press conference except to reaffirm the Fed's patience. Was there any way he was going to even hint at tapering asset purchases after Congress just passed the debt-financed "stimulus" bill he'd been urging? And was anyone still clinging to hopes he will announce "yield curve control" in the face of rising long-term Treasury yields?

- *One of two pieces of big news is that the FOMC members' estimates of future inflation in the Summary of Economic Projections finally registered at above 2%, after behaving as though above-target inflation was impossible to achieve literally ever since Powell first declared that objective* (see "Powell at Jackson Hole, and the Inflation Makeup Strategy" August 27, 2020). For core PCE inflation, the forecast is now 2.2% for 2021, 2.0% for 2022 and 2.2% for 2023 (again, see "Data Insights: Federal Reserve").



Source: FRB, Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US MACRO: For the first time since Powell announced in August the Fed's intention to seek inflation above 2%, the forecasts in the Summary of Economic projections now say it will be achieved and sustained into 2023. At the same time, the "dot plots" of the forecasted funds rate targets barely budged, despite market-implied forward rates having risen sharply since the December FOMC. The Fed is saying it "means it" about achieving higher inflation and making no move to tighten when it arrives. This is consistent with the Fed's abandonment of the Philips Curve, and its embrace of letting the economy "run hot," seeing maximum employment as an "inclusive" goal that benefits minorities and the less-educated. That there could be a more than complete recovery from the Covid Depression and a return to 3.5% employment with inflation above 2%, all with no rate hikes, could be a bit of cheerleading. But that's what it takes to make that recovery happen in the first place.

[Strategy dashboard]

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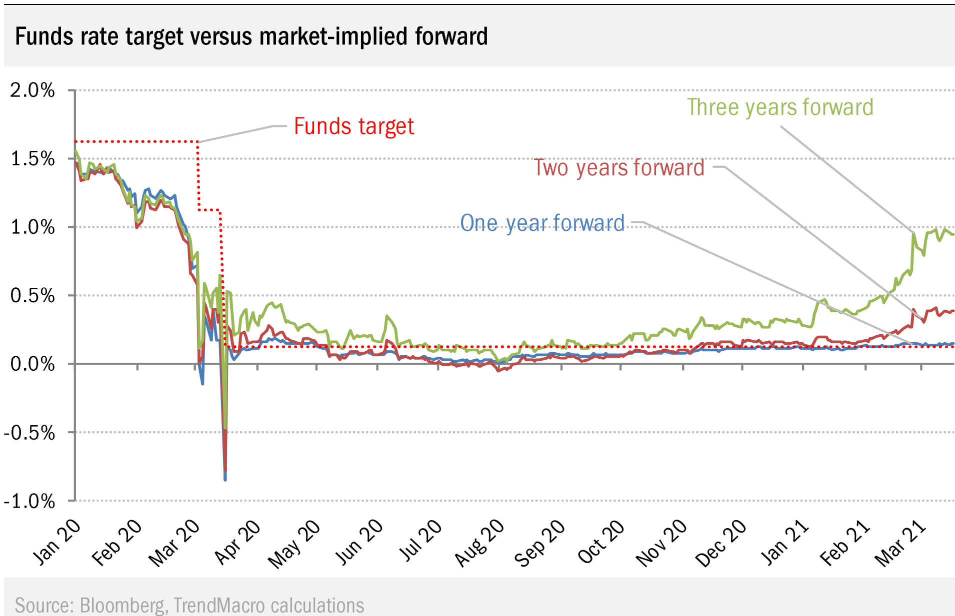
- *The other piece of big news is the very modest upgrade in the "dot-plots," the FOMC members' SEP of the "appropriate" funds rate target in 2022 and 2023*. Coming into the meeting, there was a chance the dots would be hiked in synch with market-implied forward rates that had risen sharply since the last time the dots were published at the December FOMC's SEP, when the dots and forward rates were virtually identical – showing no rate hikes in 2022 and one in 2023 (please see the chart below).



Source: Bloomberg, TrendMacro calculations

- Since then, the 2-year forward rate has risen by 25 bp, one full rate hike; yet today *the 2022 average of dots was upgraded only 8 bp*. The 3-year forward rate has risen by 65 bp, another one-and-a-half rate hikes; yet today *the 2023 average of dots was upgraded by only 14 bp* (please see the chart on the first page).
- *The critical upshot of all this is that the Fed "means it."*
- *First, it means it that inflation can and will run a little above 2%.*
- *Second, it means it that, when it does, the Fed won't tighten in response.*
- *This is all the more powerful a message given what might have been seen as a green light from markets to indicate a policy tightening in the future.*
- This is set against a background in which the SEP strongly upgraded 2021 GDP growth from 4.2% to 6.5%, 2022 GDP from 3.2% to 3.3% -- and then downgraded 2023 growth from 2.4% to 2.2%. *Sounds like, other than the slightly higher inflation, the Fed is forecasting a return to what we used to call the "new normal" of "secular stagnation."*
- And yet, at the same time, the SEP is projecting a monotonic drop in the unemployment rate to 3.5% in 2023 (upgraded from 3.7% in December). *So the FOMC has decided that a "new normal" of "secular stagnation" is consistent with an unemployment rate better than that seen during the "old normal." Setting aside whether that makes any sense, the very encouraging news is that the Fed has*

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abandoned the Philips Curve, no longer thinking of low unemployment as a sufficient statistic to launch a growth-killing hiking regime.

- This is consistent with a remarkable statement made by Powell last month, which has not been sufficiently reported. In a February 10 speech, he said outright that "we will not tighten monetary policy solely in response to a strong labor market."
- *He contextualized this by stating that, for the Fed, "maximum employment is a broad and **inclusive** goal"* (emphasis added). We doubt that's an accidental use of a word – *inclusive* – that is typically used in discussing race-conscious decisions. *Maybe he chose that word in order to be seen as swimming with the present political tide, possibly positioning himself to get reappointed next year by a Democratic president. Be that as it may, it undoubtedly reflects the Fed's new awareness that low overall unemployment is consistent with the best jobs outcomes for minorities and for those without higher education – and doesn't lead to inflation* (see "The Fed Pretends to Listen" January 29, 2020).
- For all these dimensions in which we think the Fed is telling us that it "means it" about letting the economy "run hot," there is one sense in which the Fed does not "mean it." Powell said over and over in the post-meeting press conference that policy would be determined by "actual data" and similar terms, not forecasts. To be sure, there's nothing new about "data-dependency" disclaimers – but the sheer repetition of them today got our attention.
- *Our sense is that the Fed is trying to be a cheerleader here by, on the one hand, predicting better days ahead and, on the other hand, that the arrival of those better days won't call for any different policy than what he have today. So Mr. Market is probably right with its implied forward funds rates, and the dots are probably wrong.*
- That's not a bad thing, because there would be nothing remotely restrictive about a funds rate at about 1% -- where the forward curve now puts it – in a world that has, by then, truly and fully recovered from the 2020 Covid Depression. *It's just that today, the way the Fed needs to tell markets that it "means it" is to forecast a funds path that it probably knows full well it doesn't mean. That bit of cheerleading is surely helpful in shaping the psychology that will enable that recovery.*

Bottom line

For the first time since Powell announced in August the Fed's intention to seek inflation above 2%, the forecasts in the Summary of Economic projections now say it will be achieved and sustained into 2023. At the same time, the "dot plots" of the forecasted funds rate targets barely budged, despite market-implied forward rates having risen sharply since the December FOMC. The Fed is saying it "means it" about achieving higher inflation and making no move to tighten when it arrives. This is consistent with the Fed's abandonment of the Philips Curve, and its embrace of letting the economy "run hot," seeing maximum employment as an "inclusive" goal that benefits minorities and the less-educated. That there could be a more than complete recovery from the

Covid Depression and a return to 3.5% employment with inflation above 2%, all with no rate hikes, could be a bit of cheerleading. But that’s what it takes to make that recovery happen in the first place.