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TRENDMACRO LIVE!

On the March FOMC

Wednesday, March 16, 2022
Donald Luskin

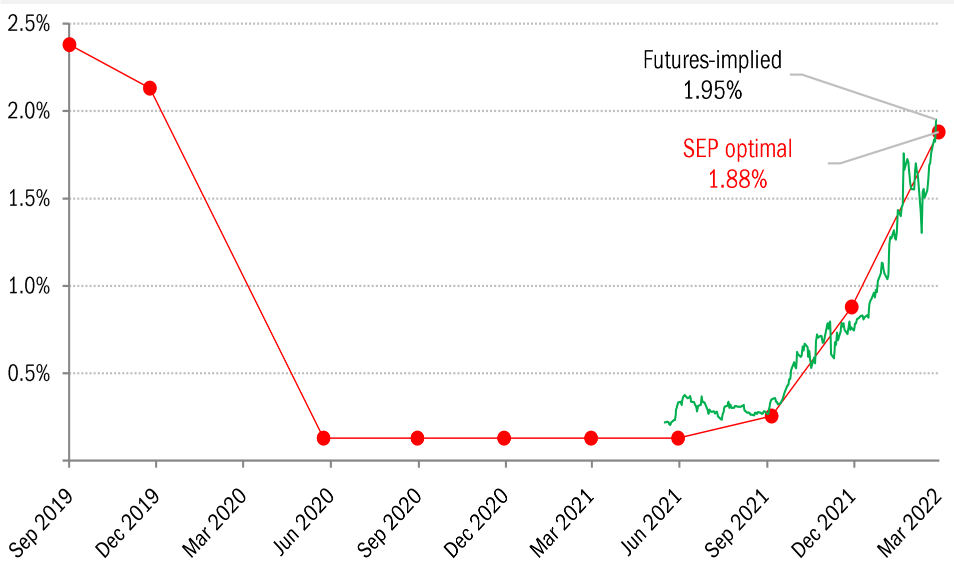
Brilliant. The Fed declares that broader price pressures are caused by broader price pressures.

Let's quickly get one thing out of the way. Sarah Bloom Raskin has withdrawn her nomination for Fed Vice Chair of Supervision in the face of united GOP opposition in the Senate, and the defection of Democrat Joseph Manchin (D-WV) – just as we predicted (see "What you're not hearing about Biden's Fed nominees" January 14, 2022). We think it is good news both that a nominee who surely would have politicized the Fed's bank-regulatory function has been shot down.

Now on to today's momentous FOMC, marking the second time in a decade that the Fed has lifted off from a period of near-zero policy rates.

- *At first blush, markets have reacted a bit negatively. But there is no surprise in today's hike of the funds rate target to a range of 25 bp to 50 bp. Both the markets and the Fed's Summary of Economic Projections have been in synch on this all along, and remain so today with the median "dot plot" for 2022 at 1.88%, basically where the Fed funds futures have already gotten to* (please see the chart below). Yes, that's true, even though four rate hikes have been built in just since the December FOMC (see "On the December

Expected funds rate for December 2022: dot-plot and market-implied



Source: Bloomberg, FRB SEP, TrendMacro calculations

Update to strategic view

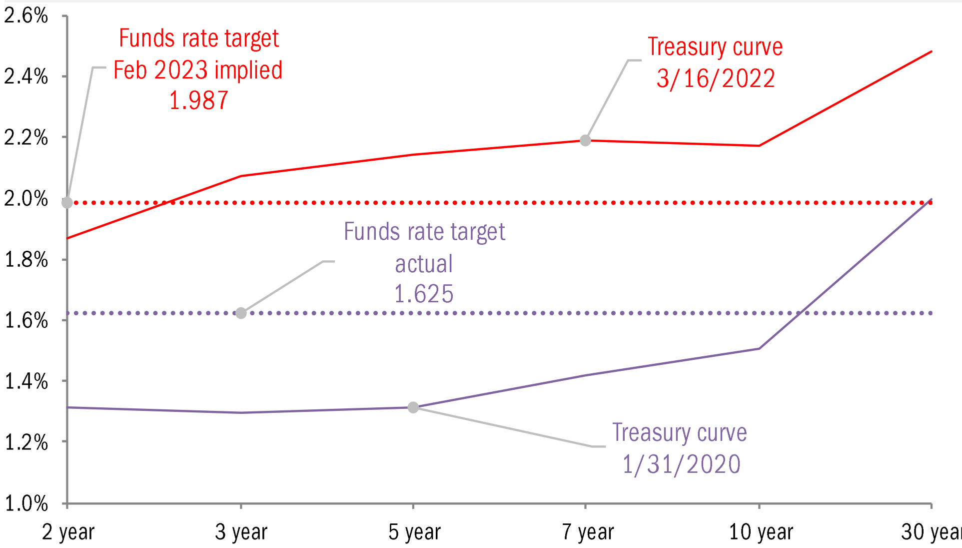
FEDERAL RESERVE, US MACRO: Liftoff after two years of near-zero policy rates, despite a sharp downgrade to 2022 growth expectations. Bullard made the first dissent in 18 months, wanting a double-hike. The "dot plots" for 2022 upgrade the optimal funds rate to 1.88%, a full percentage point higher than at the December meeting. The yield curve is, and has been, in perfect synch with this large change. The characterization of inflation has been augmented to cite "broader price pressures" as a cause – which is, in fact, a tautology – yet it is likely a token of the Fed's commitment to keep inflation expectations anchored. We still think inflation will be transitory, but liftoff is appropriate nevertheless based on all the other economic variables. Balance sheet run-off was elevated to the statement itself, as beginning at "a coming meeting." We welcome this low-impact form of normalization as a benign substitute for what might otherwise be a steeper and more growth-unfriendly path of rate hikes.

[Strategy dashboard]

[FOMC"](#) December 15, 2021). The change in just three months is so striking that the highest "dot plot" in December is lower than the lowest "dot plot" today (see "Data Insights: Federal Reserve" March 16, 2022).

- *The whole curve has already taken onboard this Fed action and more*. It's not the most bullish curve you'll ever see – the 2/10 curve is presently 31 bp. But it's worth remembering that before the pandemic struck in early 2020, and the economy was still in an all-time record economic expansion, the entire curve out to 10 years was submerged to the then-current funds rate, which itself had already been cut three times (please see the chart below). Today's curve past 2 years is above not only the current funds rate, but the much higher market-implied rate a year ahead. *The curve is not seeing a recession here at liftoff.*

The Treasury yield curve, pre-pandemic and current



Source: Bloomberg, TrendMacro calculations

- One little surprise in today's FOMC statement is that references to Covid have been completely dropped for the first time in two years. The implicit assumption is that it is no longer an influence on the economy. As always, the Fed marches to the tune of the prevailing political narrative.
- *The substantive surprise in today's FOMC statement is the recharacterization of inflation in the very first paragraph*. Of course the word "transitory" is gone. But now inflation, while still blamed on "supply and demand imbalances related to the pandemic," is now also attributed to "broader price pressures."
- *Wait – are you telling us that broader price pressures are caused by broader price pressures?* Surely the world's largest employer of academic economists can do better than that. All we can do is take it as a token that the Fed wishes to express its general concern.
- We have to take that as market-negative, at least to some extent, because we are not very worried about the potential persistence of

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inflation (see "Video: What you're not hearing about inflation's canary in the coal mine" March 14, 2022).

- Once again, in the post-meeting press conference Powell framed the Fed's objective on inflation as assuring inflation expectations remain well-anchored. That's a statement about controlling the *future* level of expectations, to be sure. But it's nevertheless important to observe that for the better part of a decade those expectations have been anchored to a fault, that is, they've been too low. That's why the Fed adopted "flexible average inflation targeting" in August 2020 (see "Powell at Jackson Hole, and the Inflation Makeup Strategy" August 27, 2020). *For all the anxiety about elevated levels of CPI and PCE inflation, the fact is that expectations now are, for the first time since 2014, about where the Fed has said it wants them all along* (again, see "Video: What you're not hearing about inflation's canary in the coal mine").
- With that in mind, we don't like all the hand-wringing about inflation evident today. But at least the unhinged inflationphobia of St. Louis Fed President James Bullard, which drew him to make the first FOMC dissent in 18 months – he wanted a 50 bp hike rather than 25 bp – didn't infect anyone else.
- All that hand-wringing is set against a downgrade in the SEP's forecast of 2022 GDP growth, from 4.0% to 2.2% -- suggesting that the Fed is worried enough about inflation that it won't hesitate to raise rates even as growth decelerates. In the post-meeting press conference, Chair Jerome Powell attributed it to stresses imparted to the US economy by the Russian invasion of Ukraine. But in the statement, the only consequence of the crisis was said to be "additional upward pressure on inflation."
- Oil prices, elevated by a risk premium commanded by the Ukraine crisis (see "The Bear/Bull Case in the Russian Oil Ban" March 16, 2022), are a particular conundrum for the Fed here. We don't think that the Fed should be worried that they're about to tip the economy into an oil-shock recession, at least not at these levels (see "Video: What you're not hearing about the coming oil shock" March 7, 2022). Ironically, the prior time the Fed lifted off from zero policy rates, in December 2015 (see "On the December FOMC" December 16, 2015), we had very different concerns about oil. Then prices were falling catastrophically as newly minted oil from US fracking began to rebalance the global supply and demand balance toward glut, and it was already spilling over into US credit markets thanks to the debt-heavy drilling sector – *that* in its own way was more of an oil-shock risk than what we are facing now (see "The Recession Caused by Low Oil Prices" January 8, 2016).
- *Abstracting from geopolitical risks, we have no doubt whatsoever the lifting off is an appropriate policy move*. Without even considering inflation one way or the other, it's time to lift off, based simply on the self-evident normalization of most elements of the economy. You can set the inflation rate to, say, 2% – completely ignoring the fact that it's currently more than three times that – and any "monetary policy rule" will still tell you to lift off now, based on all the other inputs (see "Video: What you're not hearing about the coming Fed tightening cycle" February 18, 2022).

- It's not a surprise exactly, but the FOMC statement said for the first time that the Fed now "expects to begin reducing its holdings of Treasury securities and agency mortgage back securities at a coming meeting." At the January FOMC, this idea had been relegated to the post-meeting press conference, bolstered by publication of an entirely separate statement discussing the likely operating characteristics of such a run-off.
- This is a departure from the era following QE3, in which two whole years went by from the conclusion of tapering purchases to the onset of running off assets – this time, it looks like the gap will be three months or less.
- *We see this as a bullish policy development, as it allows the Fed to be more cautious and gradual with rate hikes* by deploying a policy tool that is likely to satisfy those who, right or wrong, want the Fed to "do something" about inflation, while having almost no actual market impact (see "A Turn Signal for the Fed's Off-ramp on the Road to Rate Hikes" January 31, 2022 and "Video: What you're not hearing about the Fed's 'quantitative tightening'" January 7, 2022).
- *Going forward, the key will be to see the extent to which inflation proves indeed to be transitory, as we have said it would all along, well before Powell adopted the word. We think it will, and as it does, the Fed will be in the delicious position of being able to claim credit for it – even though it didn't cause it in the first place, and even though its current policy path ought to have no effect on it.*

Bottom line

Liftoff after two years of near-zero policy rates, despite a sharp downgrade to 2022 growth expectations. Bullard made the first dissent in 18 months, wanting a double-hike. The "dot plots" for 2022 upgrade the optimal funds rate to 1.88%, a full percentage point higher than at the December meeting. The yield curve is, and has been, in perfect synch with this large change. The characterization of inflation has been augmented to cite "broader price pressures" as a cause – which is, in fact, a tautology – yet it is likely a token of the Fed's commitment to keep inflation expectations anchored. We still think inflation will be transitory, but liftoff is appropriate nevertheless based on all the other economic variables. Balance sheet run-off was elevated to the statement itself, as beginning at "a coming meeting." We welcome this low-impact form of normalization as a benign substitute for what might otherwise be a steeper and more growth-unfriendly path of rate hikes.