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Fed Thoughts: Wake Me When September Ends

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Federal Reserve (Fed) officials leave no room for doubt about their design for policy in the near term. They stuck to an identical message in recent speeches and interviews and gave it an official imprimatur in the recently released minutes of the Federal Open Market Committee (FOMC). The Fed is following muscular gradualism in raising the policy rate 50 basis points at its most recent meeting and signaling the intent to follow up with like-sized moves at the "next couple of meetings."

Policy gradualism is a familiar harvest from the central bank vineyard, which makes the next section of predicting the outcome of the June FOMC meeting pretty straightforward. However, by putting this new wine into the old wine skins of its pre-existing communications strategy, Fed officials risk a Biblically problematic result. That is, as the Fed marches the fed funds rate up over the course of 2022, some of the flexibility that gradualism usually offers may be negated by its standard guidance about the longer term. The other aspect of the Fed's journey in 2022, addressed in the last section, is that it will get increasingly bumpier by design. By choosing gradualism, we believe members of the FOMC are agreeing to address a problem of uncertain dimension in repeated, bite-sized portions. Everyone can agree on the initial nibbles, but as time passes, quibbles about the need for more will become increasingly common.

The Same, But Different

Policy-rate setting by central banks is always gradual across countries and over time. However, this is usually an outcome, not an explicitly communicated design as has been the case with the latest turn by the Fed. The notable exception was the Greenspan-begun firming cycle of 2004 and 2005, when the funds rate was raised at a "measured pace." Back then, the measured pace was 25 basis points, and the signal by its inclusion in the FOMC statement represented only a commitment to act at the next meeting, not the next couple.

This time, to quote Chair Powell from his most recent press conference, "…our expectation is, if we see what we expect to see, then we would have 50-basis-point increases on the table at the next two meetings," doubling the policy move and the length of the commitment.[1] Two features of the current cycle explain the muscular departure from the Greenspan precedent that had justified his nickname, "Quarter-point Al."

For one, Chair Powell's Fed has a more pressing problem than that of Chair Greenspan. The latter began firming when inflation was about at the Fed's two-percent goal and was designed to keep it there. The former is playing catch-up with inflation at heights not seen in forty years and an unemployment rate near its all-time low.

For another, the current communications infrastructure is considerably more elaborate. The FOMC statement has to align with the quarterly Summary of Economic Projections (SEP), which includes participants' views of the appropriate policy path over the next few years—also known as the "dot" plot. Greenspanian constructive ambiguity of limiting guidance to the next meeting alone would come across as so last century in a world in which officials lay out a policy track for a half decade.

At the upcoming FOMC meeting, watch for what they disagree about in the SEP, not their common ground in the statement. Yes, we know that they care so much about regaining price stability that the funds rate will go up 50 basis points at that and the next meeting. Turn that page quickly to the outlook.

The distribution of dots for end-2022 will indicate how many believe that 50-basis-point moves will extend into September. It is probably a majority, but a few speakers have already put both slowing or a pause on the table. The end cloud of dots shows their assessments of the neutral rate, which might plausibly shift up because of the evident momentum to aggregate demand. But don't count on much movement because of individual inertia. The more reliable expectation is that they retain quite divergent views about where the economy will settle, implying that the disagreement gradualism puts off will come to the fore in the fall. In between 2022 and the longer run, how many envision considering imposing policy restraint (not just removing ease as they currently are) by predicting that the funds rate overshoots its neutral rate? This will still be a minority, but a larger and stubborn one.

Did they learn a lesson from their March announcement? At that meeting, they likely believed that the headlines would trumpet their policy pivot, with the dots indicating 25-basis-point policy moves at the remaining meetings of the year. In the event, they were roundly criticized for the unreality of their outlook of a virtuous decline in inflation even as the unemployment rate tracked below its natural rate and the real policy rate stayed in negative territory in 2022. If they learned, then they will admit inflation will end this year above 5 percent and the unemployment rate will turn up. The latter could prove problematic for Chair Powell in the press conference by fueling talk of recession. As economist Bill Dudley rightly points out, the business cycle is decidedly nonlinear, and it doesn't take much of a rise in the unemployment rate to tip output over.

Recognize that this precedent of openness about the medium term undercuts one of the two advantages of gradualism.

Not the external purpose of gradualism, which is committing to a gradual path to allow market participants to build future policy moves into current constriction of financial market conditions. This has happened, which is why the ten-year Treasury yield flirts with 3 percent, equity prices are off markedly, and the dollar appreciated. It is a channel appreciated by policy makers, as expressed by Chair Powell at the press conference when he explained that "…monetary policy is working through expectations now, to a very large extent."[2]

The modern communications framework, however, erodes the internal purpose of gradualism, which is emphasizing agreement among a disputatious policy committee. While Fed officials agree neither as to the ultimate destination of the funds rate (with a 1 percentage point spread in their reported neutral rates) nor whether some overshoot of neutral is necessary, they all believe that its current level is too low. Indeed, it is so short of the mark that they can agree to a few near-term 50-basis-point moves. We think this leaves the material difference in their longer-term views to be litigated later in the year. However, the dot plot emphasizes the differences among terminal dots, not the latter unity about the near term expressed in the statement.

Wake Me When September Ends

In our view, there is an element of irony in that Chair Powell would quite apparently love to live without the SEP. At his press conferences, he appears to follow Scarlett O'Hara's advice that tomorrow is another day by refusing to get out of the here-and-now of the current decision. We hear from him everything the SEP is not—not a contract, not agreed upon by the committee, and not even usually talked about by the committee. Gradualism, however, widens the relevant time frame into a couple of days (or meetings). This characterization of the front end of the path of the policy then has to knit into the dot plot, and the SEP moves to the front and center of the policy discussion.

We believe the other irony of gradualism is that it represents the agreement to disagree, albeit at a later date. The FOMC will apparently unanimously roll through at least two more 50-basis-point policy hikes because all its members believe that the current nominal fed funds rate is nowhere near the level needed to slow the growth of demand. But this motion brings the level of the funds rate closer to the bottom end of expectations of its neutral rate by September. By that time, inflation will likely have come off its peak, financial market conditions will have tightened considerably, and the unemployment rate will be rising.

Those meetings later in the year should get more interesting as differences of opinion within the group come to the fore. And the group will change as six new governors and Bank presidents get up to speed, all of whom will likely be more dovish than the incumbents they replace.

We think that the Fed will slow down later in the year with two 25-basis-point hikes followed by a pause at the end of the year, although whether they will retain their aggressiveness for one more meeting is uncertain in our view. Even without a pause and another 25-basis-points tossed into the mix, we believe what they appear to have planned will fail to quell inflation as quickly as they hope. The supply shocks hitting the global economy are considerable, the cost-price spiral is widening, and inflation expectations are a one-way bet higher. Despite the Fed's more aggressive tone, the nominal policy rate will track below inflation this year and into next. Unconventional tightening in the form of running off assets (to be announced at the upcoming meeting) will modestly trim a still-large balance sheet, suggesting only a small proportional change in the Fed's footprint relative to private sector holdings. In our view, the result will sustain inflation well above the official two-percent goal, somewhere around 6 percent at the end of this year and 4 percent in 2023.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

[1] "Transcript of Chair Powell's Press Conference", May 4, 2022, at federalreserve.gov, p. 8.
[2] "Transcript of Chair Powell's Press Conference", May 4, 2022, at federalreserve.gov, p. 20.

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