Transcript

Bill Emmons: Hi. I'm Bill Emmons, and I'd like to talk about the FOMC meeting that took place December 14 and 15. I would characterize this as a pivot meeting, although much of the action in the Treasury market occurred before the meeting. So, the takeaways include unchanged interest rate targets for now. The bond taper, which was announced in November, has been accelerated. The pace of tapering will double, and this will bring large-scale asset purchases to zero by mid-March 2022. Also, this was a quarterly release of the summary of economic projections. The 2021 economic growth was revised down slightly. A median number believes rather than the 5.9% expected as of September, now 5.5% for this year. Unemployment revised down from 4.8 to 4.3% in the fourth quarter of this year. Inflation moved up from 4.2% to 5.3% in the most recent projections in the year ending fourth quarter of this year. And, there are now three quarter-point Fed Funds rate hikes expected in 2022.

So, looking first at the economic growth projections, this picture shows, meeting by meeting, as these quarterly projections try to gauge what the strength of the economy will be in each of the next four years. In this most recent revision, there was a reduction from 5.9% to 5.5% this year, but a slight upward revision from 3.8 to 4.0% in 2022. Even out into 2023, the committee is expecting slightly above what we think of as the longer run potential growth rate of the economy. Looking at unemployment in the most recent revisions, for the end of this year, the expectation is now 4.3%. Looking into the end of 2022, the median number now expects unemployment to be down at 3.5%, which is below the 4% longer run sustainable level, and this is expected to continue into '23 and '24. So, this is indicative of a very tight labor market.

Inflation, meanwhile, was revised up significantly. As of September, the expectation was only 4.2%. Now, the committee's median number is looking at 5.3% for this year. Also, next year, upward revision of four-tenths of a percent from 2.2 to 2.6%, noticeably above that longer run 2% target the Fed is trying to hit. And, the path of the Fed Funds rate has shifted up. So, rate hikes, which not that long ago were not expected to begin even until 2024, now are expected to begin in 2022. As of the end of next year, the median number expects that Fed Funds rate to average 0.9%. Looking at the end of '23, now up to 1.6%. At the end of '24, 2.1% average on the Fed Funds rate, which is still below what the committee believes is the longer run neutral level of the Fed Funds rate of 2.5%.

So, as I mentioned, the real action in the Treasury market was between the last two meetings. If you look at the left-hand column in this picture—that's the day of the November meeting—there was a small increase across most maturities at the announcement that the Fed would begin the tapering of the asset purchases. Then, look over on the right-hand side, this was the effect of the day of the announcement of the acceleration of the taper, as well as a significant upward revision of the path of the Fed Funds rate. Again, not a lot of movement there. The real action happened between the meetings. You can see in the middle column there, on net, there was a big increase in the intermediate yields and, at the same time, a big decrease in the longer-term yields, which gives you a flattening yield curve. This is indicative of the Fed tightening financial conditions as the markets look ahead.

So, one of the big questions, of course, is how did the Fed get inflation so wrong and does it matter? I would say, first, to be fair, most economic forecasters missed badly this year. The median inflation projection a year ago, that is in December of 2020 looking into this year, was only 1.8%. That's now been revised up by 350 basis points to 5.3%, but most forecasters badly underestimated how strong inflation would be this year. On the other hand, the Fed was too pessimistic about GDP growth and unemployment, both of which are coming in quite a bit better than expected this year. I think, though, it's still fair to say a legitimate criticism of the Fed is why, even as late as June of this year, the inflation projection now looks like it was low by almost 200 basis points. And, the way the Fed was describing the inflation as transitory up until November seems like maybe a little bit slow to recognize what was happening. And so, there now is some discussion in markets about whether the Fed is behind the curve, which would risk more aggressive increases in rate hikes at some point in the future.

So, implications for banks include something we've been talking about for quite some time. The economy is running very hot. Labor shortages and supply bottlenecks continue for many businesses and for banks themselves. CPI inflation, most recent reading, 6.8% from a year ago, is the highest since February of 1982. So, it's not surprising that the short-term interest rate increases announced by these projections yesterday are likely to begin in May of 2022, benefitting asset-sensitive banks. Loan growth, meanwhile, finally picking up as the economy grows rapidly into next year.

So, what should we expect? Labor markets, I think, are going to tighten further as spending remains strong and the unemployment rate declines well below 4%. Inflationary pressures, I think, may intensify before they recede. And, the flattening Treasury yield curve reflects the Fed's efforts to tighten financial conditions. And, the FOMC meeting signaled more to come on this front. And, the risk is, that if the Fed truly is behind the curve, rates could move up faster or further than is now expected by financial markets. And, I think that's really the main risk as we look into 2022. Thanks for listening, and I'll see you next time.

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