December 16, 2022

Fed Predicts Fed-Funds Rate Above 5% Through 2023, but Markets Don't Buy It

Transcript

Bill Emmons: Hi. I'm Bill Emmons, and I'd like to talk about the FOMC meeting that took place December 13 and 14. At this meeting, the Fed projected the fed funds rate above 5% in 2023, but financial markets aren't buying it. So, after four 75 basis point moves, the Fed raised its interest rate targets by 50 basis points at this meeting. This brings the target range to 4.25 to 4.5%. Quantitative tightening, the shrinking of our balance sheet, continues, but it's very modest. The Fed's securities portfolio has decreased $366 billion since April of this year, but that's only a 4% decline.

At this meeting, the Fed brought out its quarterly summary of economic projections, and the outlook continues to be stagflationary. Economic growth is expected to be 0.5% this year, and again 0.5% in 2023. Meanwhile, inflation is projected at 5.6% this year and 3.1% next year. Unemployment currently at 3.7%. It's expected to be around 4.5% at the end of each of the next three years. As for monetary policy, the FOMC now projects a 5.1% fed funds rate at the end of 2023, and presumably that would be reached earlier in the year. And that rate would decline to 4.1% the following year, 2024. Balance sheet runoff will continue throughout this year coming up.

So, first, economic growth. As I often do, show you the progression of these estimates as we go through time. So, looking at the 2023 estimates in particular, you can see that originally in December of 2020, the year was projected to be at 2.4% growth rate. A year later, 2.2, and, most recently, 0.5, and that reflects the deteriorating economic growth outlook. As for unemployment, similarly, the unemployment rate projected for the end of 2023 now is more than a percentage point higher than was expected at the end of last year. For inflation, we've had very significant increases through 2021 and 2022. Looking into 2023, that projection going from 2% all the way up to 3.1% now. As for the fed funds rate, the increase very, very steep through 2023; looking at 5.1% at the end of the year, stepping down to 4.1 and then 3.1% in the following two years.

So, the markets don't actually see quite that much tightening. The markets are expecting only 50 basis points of additional tightening, so that would put the fed funds rate somewhat under 5% by early 2023. So, we've been through quite a few increases, and probably at least two more 25 basis point increases. That's according to market projections.

So, looking at the amount of the disagreement, the Fed's SEP, summary of economic projections, puts the rate at 4.4% at the end of this year, 5.1% the end of next year, and 4.1 at the end of 2024. The orange line here shows the futures market-implied path of the funds rate, and it lies below the Fed's own projections. The gray bar shows the difference. So, at the end of 2023, there is about a 42 basis point discrepancy, and by the end of 2024, an 84 basis point discrepancy. So, the market is expecting less tightening than the Fed is currently projecting.

What does it mean for banks? Well, the Fed projections of the economy imply another year of stagflation in 2023—another year of essentially no economic growth and inflation well above target. Also, unemployment will be rising. The inverted Treasury yield curve points to a recession, although that's not explicitly the outlook by the Fed. The slow but steady quantitative tightening is draining reserves from the banking system. It is amplifying the tightening of financial conditions induced by higher interest rates, and we know that borrowers' credit quality will come under more pressure in 2023 with those rising rates and the slow economic growth.

So, what should we expect? The Fed projects the fed funds rate to be above 5% for most of 2023. Financial markets are implying that a peak will be under 5%, and they see cuts beginning before the end of 2023. In my view, financial conditions will need to tighten further to drive inflation back to 2%. It appears to me that the market is too sanguine. And I'd like to mention that this is my final episode of *Take Five*, as I am retiring at the end of 2022. Best of luck to everyone.

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