TAKE FIVE with Bill Emmons

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Fed Steps Up Inflation Fight with Aggressive Rate Hike

Transcript

Bill Emmons: Hi. I'm Bill Emmons, and I'd like to talk about the FOMC meeting that took place June 14 and 15. The Fed stepped up its fight against inflation with an aggressive rate hike. The main meeting takeaways include 75 basis point increases in all of the Fed's interest rate targets, and the beginning of quantitative tightening. The first securities issue matured and will not be replaced from the Fed's portfolio.

In terms of the economic outlook, which the Fed updates quarterly, this has deteriorated since the end of last year. So, in particular, economic growth for this year had been expected at about 4% as of last December's projections; that has now fallen to less than 2%.

The inflation forecasted this year was 2.6% as of last December. That has now doubled to 5.2%, and the slower growth and far-above-target inflation levels are expected to continue in 2023 and '24. The near-term outlook for monetary policy includes continuing policy tightening. The FOMC signaled at this meeting that the fed funds rate could be in the range of 3.4 percent by the end of this year. Also, the drawdown of the Fed's nine trillion dollar portfolio will accelerate later this year.

Let's look at some of those projections. First, from the summary of economic projections, December 2021 projection by the median member of the committee was that we would have 4% growth in 2022. That was scaled back to 2.8% in March, and then this month, in June, to 1.7%, which is slightly below the longer-run projection for what the economy's sustainable growth rate is.

Looking at unemployment, the changes were less dramatic, but also a little bit weaker, so unemployment now expected to be 3.7% at the end of this year, versus previously 3.5%. And that's about where we are right now with unemployment.

And then, inflation. The PCE inflation rate was projected at the end of last year to be 2.6% this year, but that has moved up as inflation ratings have come in consistently higher. In March, the expectation was moved up to 4.3% for this year, and then, in June, all the way up to 5.2%—so a doubling of inflation projections in just that six-month period.

The Fed is now projecting a much steeper, faster tightening of monetary policy. The path of the fed funds rate now goes well over 3%—over the longer-run neutral 2.5% level. I highlight that just in the last twelve months, between June of 2021 and June of '22, there's been about a 300—or, actually, more than 300—basis point increase in where that median member expects the fed funds rate to be at the end of this year. Similarly, in 2023, more than 300 basis points higher than was the expectation just a year ago.

Markets and the Fed have converged. They're very close together now in the expectations. Markets are about a quarter point higher than the Fed's projections for the end of this year. After the 75 basis point increase at the June 15 meeting, the expectation in markets is that there will be another 75 basis point increase in July, and then moving to 50 basis points in both September and November, and, finally, 25 basis points in December, which would bring the target range to just over 3.5%.

I think the implications for bank, first and foremost, the Fed is seeking to tame inflation—that's job one—and regain control of the economic narrative with a series of aggressive rate hikes. The fed funds rate could approach 3.5% by the end of this year, and possibly even 4% by the end of 2023. And this is according both to the FOMC's own projections and what we can read from financial markets.

We are ramping up quantitative tightening from a very slow beginning, but by the end of this year it will be proceeding at a significant pace, and we really don't know what effects that will have on financial markets and how that will interact with the rate-based monetary policy actions. There are some clear signs that the economy is slowing. You can see that especially in housing, but other areas like consumer durables, and even business investment, are starting to show some of those slowing signs.

I think what you should expect is that the Fed will continue to tighten aggressively, and this is going to continue until clear signs appear that inflation is heading down. That's been made crystal clear by Chairman Powell. The flattening yield curve associated with those rising short rates signals a growing risk of recession, and that could even be later this year, and certainly the risk is very important in 2023.

I think, overall, tightening financial conditions and the slowing economy could increase stress in bank loan portfolios and, as rates rise, impose losses on securities portfolios of banks. Thanks for listening, and we'll see you next time.

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