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Fed Hints At Rate Target Above 5%

Transcript

Bill Emmons: Hi. I'm Bill Emmons, and I'd like to talk about the FOMC meeting that took place November 1st and 2nd. The real action took place after the meeting, at the press conference, where the chairman hinted that interest rates are likely going to have to go higher than previously expected, possibly over 5%. So, the main takeaways from the meeting included a 75-basis point increase in all the Fed's target rates and ranges. This is the fourth meeting in a row of that size increase. This brings the target range to 3¾% to 4%. Quantitative tightening, the runoff of the Fed's balance sheet, continues. It's still ramping up toward that intended pace of $95 billion per month. As the Fed intended, the economy is slowing, but inflation remains stubbornly high. Signs of weakness across the economy are emerging with the notable exception of the labor market. Meanwhile, core inflation measures and labor costs have not slowed, so Chairman Powell signaled that there will likely be even higher interest rates than we previously thought. You might recall in September, the Fed was signaling about a 4.4% interest rate in the late part of 2022, rising to probably 4.6% in early '23. At the press conference, Chairman Powell hinted that that target range is likely going to have to go higher, possibly over 5%.

So, let's look at the economy. Eighth District unemployment rates have come down a lot since the COVID shock, but they started to level off. In fact, if you look closely, there are even a few signs that unemployment might be rising just a little bit, but this is still not enough. This is not enough of a slowdown in the labor market to achieve the disinflation that the Fed is looking for. And, in fact, those inflation gauges are stubbornly high. Here is a picture that shows a variety of measures of trying to gauge just how strong are those inflationary pressures, and they're all pushing up, way above the 2% target. In fact, if you look at the key inflation indicators that the Fed uses, the personal consumption expenditures, or PCE, chain price index, it's rising at still over a 6% rate year-over-year. Stripping out food and energy, even the core measure is rising at about a 5% rate, and employment costs here are measured by the employment cost index, capturing both wages and benefits. That's also rising at a 5% rate. All of those are far too high, way above the 2% target. As we've seen, the Fed has been engaged in a steady march higher with interest rates. Now, it looks like there will be possibly a 50-basis point increase in December, another 50 in February, and maybe 25 as late as March. These are based on market projections. So, that would bring another 125 basis points, bringing us up over 5% early next year.

So, I've showed in the past, the steady increase in the path of the Fed funds target expected by the Fed. This most recent meeting suggests that we're going to go even higher, probably over 5%, early next year. There is also a question of what the longer-term Fed funds rate will be, the so-called neutral rate. This is distinct from the terminal rate, the idea of what will be the peak rate in the cycle. One way to gauge this is to look at some market expectations. So, the one-month T-bill is a pretty good measure of the Fed's policy rate, the Fed funds rate. You can see that it's risen fairly rapidly this year, and based on what the Fed has been saying about what we

think that longer run or neutral level is, this moves the rate into restrictive territory. However, there is also a view that maybe that longer-run level is better gauged by looking at long-term forward rates in the Treasury market. Now, if we look at, for example, a 10-year forward rate, that has moved up a lot and now suggests that the neutral rate is higher than it was previously. So, looking more closely, it could well be 4% or higher. So, this means that, even after this cycle, the Fed funds rate may settle at a level higher than was previously expected.

So, what are the implications for banks? This relentless increase in interest rates will continue. It's decreasing the value of banks' fixed-income portfolios. Aggressive Fed tightening and indications of slowing growth suggest that a recession is imminent. Quantitative tightening will continue, and that's draining reserves from the banking system; that amplifies the tightening of financial conditions induced by higher interest rates. And, of course, borrowers' credit quality will suffer with higher rates and a slowing economy. What should we expect? Despite 375 basis points of tightening so far in 2022, my judgment is the Fed remains behind the curve in its battle against inflation. Market indicators and Fed communication now point toward a terminal, that is peak, for this cycle; a terminal Fed funds rate above 5%. Likewise, the longer-run or neutral Fed funds rate…so after all of these cyclical fluctuations have passed through…that also appears to have increased from about 2.5% to possibly as high as 4%. And the cumulative effects of monetary policy tightening during this year and next will weigh heavily on economic growth, employment, and bank earnings in the quarters to come. Thanks for listening, and we'll see you next time.

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